

TELEFONOS DE MEXICO S A DE C V

Form 6-K

January 23, 2006

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## **FORM 6-K**

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# **SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**Report of Foreign Private Issuer**

**Pursuant to Rule 13a-16 or 15d-16 under  
the Securities Exchange Act of 1934**

For the month of January 2006

Commission File Number: 333-13580

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## **Teléfonos de México, S.A. de C.V.**

(Exact Name of the Registrant as Specified in the Charter)

## **Telephones of Mexico**

(Translation of Registrant's Name into English)

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**Parque Vía 190**

**Colonia Cuauhtémoc**

**México City 06599, México, D.F.**

**(Address of principal executive offices)**

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Indicate by check mark whether the registrant files or will file annual reports under cover Form 20-F or Form 40-F.

Form 20-F  Form 40-F

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(1):

Indicate by check mark if the registrant is submitting the Form 6-K in paper as permitted by Regulation S-T Rule 101(b)(7):

Indicate by check mark whether by furnishing the information contained in this Form, the registrant is also thereby furnishing the information to the Commission pursuant to Rule 12g3-2(b) under the Securities Exchange Act of 1934.

Yes  No

If  Yes is marked, indicate below the file number assigned to the registrant in connection with Rule 12g3-2(b): 82-

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**Report dated January 23, 2006**

**Teléfonos de México, S.A. de C.V.**

We have prepared this report to provide investors with disclosure regarding recent developments in our business and our results of operations for the nine-month period ended September 30, 2005. The information in this report updates information contained in our annual report on Form 20-F for the year ended December 31, 2004 (SEC File No. 1-10749), filed with the Securities and Exchange Commission on June 28, 2005, which we refer to as the 2004 Form 20-F.

This report is hereby incorporated by reference in our registration statement on Form F-3 (SEC File No. 333-111040), filed with the SEC on December 10, 2003.

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**Exhibits**

- Exhibit 1. Unaudited Condensed Consolidated Interim Financial Statements
- Exhibit 2. Calculation of Ratio of Earnings to Fixed Charges (supplements Exhibit 7.1 included in our Form F-3)

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**PRESENTATION OF FINANCIAL INFORMATION**

The financial information appearing in this report is derived from our interim financial statements. Our financial statements are prepared in accordance with generally accepted accounting principles in Mexico, or Mexican GAAP. Mexican GAAP requires restatement of all financial statements to constant Mexican pesos as of the date of the most recent balance sheet presented. All financial information presented in this report is accordingly stated in constant pesos with purchasing power as of September 30, 2005.

Our 2004 Form 20-F contains audited consolidated financial statements as of December 31, 2004 and 2003 and for the years ended December 31, 2004, 2003 and 2002, stated in constant pesos with purchasing power as of December 31, 2004. As a result of Mexican inflation (estimated) during the first nine months of 2005, the purchasing power of one peso as of December 31, 2004 is equivalent to the purchasing power of 1.0182 pesos as of September 30, 2005. Therefore, our unaudited condensed consolidated interim financial statements and the financial information appearing in this report are not directly comparable to our audited financial statements and the financial information contained in our 2004 Form 20-F because they are stated in constant pesos as of different dates.

Mexican GAAP differ in certain respects from generally accepted accounting principles in the United States, or U.S. GAAP. See Note 19 to our audited consolidated financial statements included in our 2004 Form 20-F and Note 14 to our unaudited condensed consolidated interim financial statements.

References in this report to U.S. dollars or U.S.\$ are to the lawful currency of the United States. References herein to pesos, P. or Ps. are to the lawful currency of Mexico. References herein to reais or R\$ are to the lawful currency of Brazil.

This report contains translations of various peso amounts into U.S. dollars at specified rates solely for your convenience. You should not construe these translations as representations by us that the nominal peso or constant peso amounts actually represent these U.S. dollar amounts or could be converted into U.S. dollars at the rate indicated. We have translated peso amounts into U.S. dollars using the exchange rate of Ps.10.8495 to U.S.\$1.00, which is the exchange rate reported by Banco de México for September 30, 2005.

With respect to results for the year ended December 31, 2004, we have translated real amounts into pesos using an exchange rate of R\$0.2573 to Ps.1.00, based on the average of the real to U.S. dollar and U.S. dollar to peso exchange rates reported by the Central Bank of Brazil and Banco de México, respectively, for the last day of each month in the period from January 1, 2004 through December 31, 2004. With respect to results for the nine-month period ended September 30, 2005, we have translated real amounts into pesos using an exchange rate of R\$0.2234 to Ps.1.00, based on the average of the real to U.S. dollar and U.S. dollar to peso exchange rates reported by the Central Bank of Brazil and Banco de México, respectively, for the last day of each month in the period from January 1, 2005 through September 30, 2005.

**FORWARD-LOOKING STATEMENTS**

This report contains forward-looking statements. Forward-looking statements involve inherent risks and uncertainties. We caution you that a number of important factors could cause actual results to differ materially from the plans, objectives, expectations, estimates and intentions expressed in such forward-looking statements. For information on factors that could cause our actual results to differ from expectations reflected in forward-looking statements, see Item 3 Key Information Risk Factors in our 2004 Form 20-F.



**Table of Contents****EXCHANGE RATES**

Mexico has a free market for foreign exchange, and the Mexican government allows the peso to float freely against the U.S. dollar. There can be no assurances that the government will maintain its current policies with regard to the peso or that the peso will not further depreciate or appreciate significantly in the future.

The following table sets forth, for the periods indicated, the high, low, average and period-end noon buying rate in New York City for cable transfers in pesos published by the Federal Reserve Bank of New York, expressed in pesos per U.S. dollar. The rates have not been restated in constant currency units and therefore represent nominal historical figures.

| <u>Period</u>                      | <u>High</u> | <u>Low</u> | <u>Average(1)</u> | <u>Period End</u> |
|------------------------------------|-------------|------------|-------------------|-------------------|
| 2001                               | 8.95        | 9.97       | 9.33              | 9.16              |
| 2002                               | 9.00        | 10.43      | 9.66              | 10.43             |
| 2003                               | 10.11       | 11.41      | 10.79             | 11.24             |
| 2004                               | 10.81       | 11.64      | 11.29             | 11.15             |
| 2005                               | 10.41       | 11.41      | 10.87             | 10.63             |
| 2005:                              |             |            |                   |                   |
| July                               | 10.59       | 10.80      |                   |                   |
| August                             | 10.58       | 10.90      |                   |                   |
| September                          | 10.68       | 10.89      |                   |                   |
| October                            | 10.69       | 10.94      |                   |                   |
| November                           | 10.57       | 10.77      |                   |                   |
| December                           | 10.41       | 10.77      |                   |                   |
| 2006:                              |             |            |                   |                   |
| January (through January 20, 2006) | 10.52       | 10.64      |                   |                   |

(1) Average of month-end rates.

On January 20, 2006 the noon buying rate was Ps.10.52 to U.S.\$1.00.

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**SUMMARY OF OUR BUSINESS**

We own the largest telecommunications system in Mexico. We operate in the Mexican markets for wireline voice telecommunications and Internet and data service. We also provide other telecommunications and telecommunications-related services such as corporate networks, Internet services, directory services, information network management, telephone equipment sales and interconnection services to other carriers and paging services. In addition, in South America we provide data, Internet and voice telecommunications services as a result of acquisitions we made in 2004.

For the year ended December 31, 2004, we had operating revenues of Ps.138,802 million, or U.S.\$12.3 billion, and net income of Ps.27,836 million, or U.S.\$2.5 billion, based on Mexican GAAP. At September 30, 2005, we had total assets of Ps.256,871 million, or U.S.\$23.7 billion, and total stockholders' equity of Ps.114,954 million, or U.S.\$10.6 billion, based on Mexican GAAP.

Of our Ps.121,706 million of consolidated revenues for the nine-month period ended September 30, 2005, 35.6% was attributable to local service, 30.5% was attributable to long distance service, 12.5% was attributable to interconnection, 11.4% was attributable to corporate networks and 6.7% was attributable to Internet services. Other services, including yellow pages and equipment sales, accounted for 3.3% of these consolidated revenues.

**Mexican Operations**

At September 30, 2005, we had 18.1 million local fixed lines in service, up 7.8% from September 30, 2004. In long distance services, we estimate that during the nine-month period ended September 30, 2005, our share of traffic in cities open to competition was 78.4% for domestic long distance and 75.7% for international long distance calls originating in Mexico. At September 30, 2005, we had approximately 2.0 million Internet access accounts and 1.7 million connectivity billed line equivalents.

**Operations Outside Mexico**

In February 2004, we began providing data, Internet and voice telecommunications services in Brazil, Chile, Argentina, Peru and Colombia through our acquisition of substantially all of the assets of AT&T Latin America, a telecommunications service provider to corporate customers in those countries. We expanded our operations in Brazil, Chile and Argentina through further acquisitions in 2004, including Techtel in April 2004 and Metrored in July 2004 (Argentina), Chilesat in April 2004 (Chile) and Embratel in August 2004 (Brazil). The revenues from our non-Mexican operations represented 24.9% of our consolidated revenues for the first nine months of 2005.

*Brazil*

Embratel Participações S.A., or Embratel, and Telmex do Brasil Ltda., or Telmex do Brasil, are our principal subsidiaries in Brazil. We also indirectly own a 37.1% equity interest in Net Serviços de Comunicação S.A., or Net, which we acquired in March 2005. We expect to make new investments in the telecommunications business in Brazil, which could include acquiring new companies, acquiring publicly-held shares of

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Embratel, or acquiring an additional interest in Net if permitted under Brazilian law.

In October, 2005, we transferred to Embratel 100% of the capital stock of Telmex do Brasil and our 37.1% equity interest in Net in exchange for new common shares of Embratel. As a result, we own 97.3% of the voting stock and 45.4% of the non-voting stock of Embratel (72.3% of the total capital stock).

Embratel is one of Brazil's largest telecommunications services providers, operating in domestic and international long distance, data communications and local services. In 2004, Embratel reported net operating revenues of approximately Ps.28,502 million (R\$7,333 million) and net loss of approximately Ps.1,318 million (R\$339 million). In the first nine months of 2005, Embratel reported net operating revenues of approximately Ps.25,195 million (R\$5,628 million) and net income of approximately Ps.855 million (R\$191 million). Of Embratel's total revenues in 2004, approximately 57% were derived from corporate customers and the remainder from residential customers.



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Telmex do Brasil provides telecommunications services to corporate customers in Brazil's largest cities including Rio de Janeiro and São Paulo, complementing Embratel's business in those cities.

Net is the largest cable television operator in Brazil. As of September 30, 2005, Net had approximately 1.5 million connected cable television subscribers and 302 thousand subscribers to its high-speed cable modem Internet access service.

*Chile*

Through our subsidiaries Telmex Chile Holding S.A. and Telmex Corp. S.A., we provide voice, Internet and data services to more than 500,000 corporate and residential customers in Chile. To corporate customers, we provide local service, private long distance networks, virtual private networks, Internet services and other value-added services, as well as video and audio satellite links for broadcasting corporations. In the residential market, in addition to local service, we provide long distance and Internet services, including value-added services.

*Argentina*

Our principal subsidiaries in Argentina are Telmex Argentina, Techtel-LMDS Comunicaciones Interactivas, S.A., or Techtel, and Metrored Telecomunicaciones S.R.L., or Metrored. Through these subsidiaries, we provide data, Internet and local and long distance services in Argentina and operate fiber optic rings in metropolitan areas that provide "last mile" access to reach our customers.

*Peru*

Through Telmex Perú S.A., we provide domestic and international long distance services, public telephones, and data, Internet and hosting services to corporate and residential customers in Peru through a fiber optic network.

*Colombia*

Through Telmex Colombia S.A., we provide data and Internet services to corporate clients in Colombia through a metropolitan and inter-city fiber optic network. We hold licenses to provide local, domestic and international long distance service, mobile telephone service, data services, value-added services and video conferencing.

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Our principal executive offices are at Parque Vía 190, Colonia Cuauhtémoc, 06599, México D.F., México. Our telephone number is (52) 55 5703-3990.



**Table of Contents****SELECTED FINANCIAL AND OPERATING INFORMATION**

The summary consolidated financial data set forth below have been derived from our unaudited condensed consolidated interim financial statements as of September 30, 2005 and for the nine-month period then ended. In the opinion of our management, the financial data set forth below include all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of consolidated financial condition and results of operations as of the dates and for the periods specified. Results for the first nine months are not, however, necessarily indicative of results to be expected for the full year.

The unaudited condensed consolidated interim financial statements and the selected interim financial data set forth below are stated in constant pesos with purchasing power as of September 30, 2005. As a result of Mexican inflation (estimated) during the first nine months of 2005, the purchasing power of one peso as of December 31, 2004 is equal to the purchasing power of 1.0182 pesos as of September 30, 2005. Accordingly, the financial data set forth below are not directly comparable to the audited consolidated financial statements included in our 2004 Form 20-F because they are stated in constant pesos as of different dates.

|  | As of and for the nine-month period ended<br>September 30,              |            |  |
|--|---|------------|--|
|  | 2005  | 2004       | 2005   |
|  | (millions of constant pesos as of<br>September 30, 2005) <sup>(1)</sup> |            | (millions of U.S.<br>dollars) <sup>(1) (2)</sup> |
| <b>Income Statement Data</b>                   |   |            |  |
| Mexican GAAP:                                  |   |            |  |
| Operating revenues                             | Ps.121,706  | Ps.100,721 | U.S.\$ 11,218                                    |
| Operating costs and expenses                   | 86,088  | 68,864     | 7,935  |
| Operating income                               | 35,618  | 31,857     | 3,283  |
| Net income                                     | 19,835  | 17,380     | 1,828  |
| Net income per share Basic <sup>(3)(4)</sup>   | 0.859   | 0.725      | 0.079  |
| Net income per share Diluted <sup>(3)(4)</sup> | 0.859   | 0.724      | 0.079  |
| Dividends per share <sup>(3)(4)(5)</sup>       | 0.360   | 0.495      | 0.033  |
| U.S. GAAP:                                     |   |            |  |
| Operating revenues                             | Ps.121,706  | Ps.100,721 | U.S.\$ 11,218                                    |
| Operating costs and expenses                   | 88,816  | 72,060     | 8,187  |
| Operating income                               | 32,890  | 28,661     | 3,031  |
| Net income                                     | 19,643  | 17,055     | 1,810  |
| Net income per share Basic <sup>(3)(4)</sup>   | 0.851   | 0.712      | 0.078  |
| Net income per share Diluted <sup>(3)(4)</sup> | 0.851   | 0.710      | 0.078  |
| Dividends per share <sup>(3)(4)(5)</sup>       | 0.360   | 0.495      | 0.033  |
| <b>Balance Sheet Data</b>                      |   |            |  |
| Mexican GAAP:                                  |   |            |  |
| Plant, property and equipment, net             | Ps.150,586  |            | U.S.\$ 13,880                                    |
| Total assets                                   | 256,871   |            | 23,676   |
| Long-term debt                                 | 75,940  |            | 6,999  |
| Total stockholders' equity                     | 114,954   |            | 10,596   |
| U.S. GAAP:                                     |   |            |  |
| Plant, property and equipment, net             | Ps.155,930  |            | U.S.\$ 14,372                                    |
| Total assets                                   | 264,097   |            | 24,342   |

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|                            |        |       |
|----------------------------|--------|-------|
| Long-term debt             | 75,940 | 6,999 |
| Total stockholders' equity | 97,470 | 8,984 |

*(see footnotes on following page)*

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|   | <b>As of</b>         |             |
|---|----------------------|-------------|
|   | <b>September 30,</b> |             |
|   | <b>2005</b>          | <b>2004</b> |
| <b>Operating Data for Mexican Operations</b>                                    |                      |             |
| Lines in service (thousands)  | 18,135               | 16,816      |
| Internet access accounts (thousands)  | 2,025                | 1,604       |
| Billed line equivalents 64 Kbps (thousands)                                     | 1,738                | 1,374       |
| Domestic long distance call minutes for the year (millions)                     | 13,375               | 12,510      |
| International long distance call minutes for the year (millions) <sup>(6)</sup> | 5,120                | 4,668       |

- (1) Except share and per share data.
- (2) U.S. dollar amounts provided are translations from the peso amounts, solely for the convenience of the reader, at an exchange rate of Ps.10.8495 per U.S. dollar, the Banco de México exchange rate at September 30, 2005.
- (3) We have not presented net income or dividends on a per ADS basis. Each L share ADS represents twenty L shares and each A Share ADS represents twenty A Shares.
- (4) All amounts have been adjusted to reflect a two-for-one stock split effected on May 25, 2005.
- (5) Nominal amounts.
- (6) Includes incoming and outgoing traffic.

**Table of Contents****RATIO OF EARNINGS TO FIXED CHARGES**

The following table sets forth our consolidated ratios of earnings to fixed charges for each year in the five-year period ended December 31, 2004 and for the nine-month period ended September 30, 2005, in accordance with Mexican GAAP and U.S. GAAP. Earnings for this purpose consist of earnings before provision for income tax but after provision for employee profit sharing, plus fixed charges and depreciation of capitalized interest and minus interest capitalized during the period. Fixed charges for this purpose consist of interest expense plus interest capitalized during the period. Fixed charges do not take into account gain or loss from monetary position or exchange gain or loss attributable to our indebtedness.

|              | <b>Year ended December 31,</b> |             |             |             |             | <b>Nine-month<br/>period ended<br/>September 30,</b> |
|--------------|--------------------------------|-------------|-------------|-------------|-------------|--|
|              | <b>2004</b>                    | <b>2003</b> | <b>2002</b> | <b>2001</b> | <b>2000</b> | <b>2005</b>  |
| Mexican GAAP | 7.8                            | 7.2         | 6.5         | 6.7         | 4.6         | 6.6  |
| U.S. GAAP    | 7.2                            | 6.7         | 5.8         | 5.8         | 4.2         | 6.1  |

**Table of Contents****CAPITALIZATION**

The following table sets forth our consolidated capitalization under Mexican GAAP as of September 30, 2005.

|   | As of September 30, 2005 |   |
|---|--------------------------|---|
|   | (millions of pesos)      | (millions of U.S. dollars) <sup>(1)</sup> |
| <b>Debt:</b>  |                          |   |
| Unsecured, denominated in foreign currency:               |                          |   |
| Banks   | Ps. 38,726               | U.S.\$ 3,569                              |
| Suppliers credits   | 334                      | 31  |
| Financial leases  | 787                      | 73  |
| Senior notes  | 44,380                   | 4,090                                     |
| Total   | 84,227                   | 7,763                                     |
| Unsecured, denominated in Mexican pesos:                  |                          |   |
| Banks   | 1,300                    | 120                                       |
| Domestic senior notes ( <i>certificados bursátiles</i> )  | 6,600                    | 608                                       |
| Total   | 7,900                    | 728                                       |
| Total debt  | 92,127                   | 8,491                                     |
| Less current portion of long-term debt <sup>(2)</sup>     | 16,187                   | 1,492                                     |
| Long-term debt  | 75,940                   | 6,999                                     |
| <b>Stockholders equity<sup>(3)</sup></b>                  |                          |   |
| Capital stock <sup>(4)</sup>                              | 27,555                   | 2,540                                     |
| Premium on sale of shares                                 | 19,093                   | 1,760                                     |
| Retained earnings   | 121,884                  | 11,234                                    |
| Accumulated other comprehensive income                    | (65,904)                 | (6,074)                                   |
| Minority interest   | 12,326                   | 1,136                                     |
| Total stockholders equity                                 | 114,954                  | 10,596                                    |
| Total capitalization (total debt and stockholders equity) | Ps. 207,081              | U.S.\$ 19,087                             |
| Total debt as a percentage of total capitalization.       | 44.5%                    | 44.5%                                     |

(1) U.S. dollar amounts provided are translations from the peso amounts, solely for the convenience of the reader, at an exchange rate of Ps.10.8495 per U.S. dollar, the Banco de México exchange rate at September 30, 2005.

(2) Includes short-term debt.

(3) See Note 11 to the unaudited condensed consolidated interim financial statements included herein.

(4) All of our capital stock is fully paid and non-assessable.

In October 2005, we entered into a new facility that replaced our U.S.\$2.425 billion syndicated bank facility obtained in July 2004. Under the new facility, we agreed to pay a smaller margin above LIBOR and increased the total loan amount to U.S.\$2.5 billion in two tranches, one for U.S.\$1.5 billion maturing in 2009 and one for U.S.\$1.0 billion maturing in 2011.

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In the fourth quarter of 2005, Embratel's principal operating subsidiary entered into bilateral credit agreements with four banks for loans totaling an aggregate principal amount of U.S.\$130 million. In addition, it extended the maturity of a bank loan in an aggregate principal amount of U.S.\$25 million from December 2005 to November 2006.

Except as set forth above, there has been no other material change in our consolidated capitalization since September 30, 2005.



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The following table sets forth our capital structure as of September 30, 2005:

| Class                    | Number of Shares<br>(millions) | Percentage<br>of Capital | Percentage<br>of Voting <sup>(1)</sup> |
|--------------------------|--------------------------------|--------------------------|--|
| L Shares (no par value)  | 13,929                         | 61.79%                   |  |
| AA Shares (no par value) | 8,127                          | 36.06                    | 94.37%                                 |
| A Shares (no par value)  | 485                            | 2.15                     | 5.63                                   |
| Total                    | 22,541                         | 100.00%                  | 100.00%                                |

(1) Except on limited matters for which L Shares have voting rights.

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**RECENT DEVELOPMENTS**

The following discussion should be read in conjunction with our audited consolidated financial statements and Item 5 Operating and Financial Review and Prospects contained in our 2004 Form 20-F and our unaudited condensed consolidated interim financial statements included herein. Our financial statements are prepared in accordance with Mexican GAAP, which differ in certain respects from U.S. GAAP. See Note 19 to our audited consolidated financial statements and Note 14 to our unaudited condensed consolidated interim financial statements. For a description of certain changes to our accounting policies, see Note 1 to our unaudited condensed consolidated interim financial statements.

**Results of Operations for the Nine-Month Periods Ended September 30, 2005 and 2004**

*Effect of Recent Acquisitions*

In 2004, we acquired Techtel, Chilesat Corp S.A., or Chilesat, Metrored, a majority of the voting stock of Embratel, and substantially all of the assets of AT&T Latin America. In 2005, we acquired a 37.1% equity interest in Net. The consolidation of these companies affects the comparability of our 2005 results to our 2004 results, particularly since the largest of our 2004 acquisitions were not consolidated until the third quarter of 2004.

Our consolidated financial statements reflect the consolidation of these companies as follows:

Telmex Argentina, Telmex do Brazil, Telmex Chile, Telmex Colombia and Telmex Peru (holding the assets of AT&T Latin America in each respective country) (from March 1, 2004),

Techtel (from May 1, 2004),

Metrored (from July 1, 2004),

Chilesat, now Telmex Corp. (from July 1, 2004) and

Embratel (from August 1, 2004).

The revenues of these companies that are included in our unaudited consolidated financial statements together accounted for 24.9% of our operating revenue for the first nine months of 2005 and 6.6% of our operating revenues for the first nine months of 2004. We have included in our consolidated financial statements the results of Net using the equity participation method.

**Table of Contents***Summary of Operating and Net Income*

In the table below, we set forth our operating revenues, operating costs and expenses (each expressed as a percentage of total operating revenues) and operating income as well as our comprehensive financing cost, provisions and net income for the first nine months of 2005 and 2004.

|   | Nine-month periods ended September 30,                |                                    |   |                                    |
|---|---|------------------------------------|---|------------------------------------|
|   | 2005  |                                    | 2004  |                                    |
|   | (millions of constant pesos as of September 30, 2005) | (percentage of operating revenues) | (millions of constant pesos as of September 30, 2005) | (percentage of operating revenues) |
| <b>Operating revenues:</b>                                  |   |                                    |   |                                    |
| Local service   | Ps. 43,386  | 35.6%                              | Ps. 43,632  | 43.3%                              |
| Domestic long distance service                              | 28,526  | 23.4                               | 16,335  | 16.2                               |
| International long distance service                         | 10,051  | 8.3                                | 8,214   | 8.2                                |
| Interconnection service                                     | 13,758  | 11.3                               | 14,422  | 14.3                               |
| Corporate networks  | 13,918  | 11.4                               | 8,754   | 8.7                                |
| Internet  | 8,107   | 6.7                                | 5,483   | 5.4                                |
| Other   | 3,960   | 3.3                                | 3,881   | 3.9                                |
| <b>Total operating revenues</b>                             | <b>121,706</b>  | <b>100.0</b>                       | <b>100,721</b>  | <b>100.0</b>                       |
| <b>Operating costs and expenses:</b>                        |   |                                    |   |                                    |
| Cost of sales and services                                  | 24,960  | 20.5                               | 23,212  | 23.1                               |
| Commercial, administrative and general expenses             | 20,500  | 16.8                               | 15,544  | 15.4                               |
| Transport and interconnection                               | 21,781  | 17.9                               | 12,885  | 12.8                               |
| Depreciation and amortization                               | 18,847  | 15.5                               | 17,223  | 17.1                               |
| <b>Total operating costs and expenses</b>                   | <b>86,088</b>   | <b>70.7</b>                        | <b>68,864</b>   | <b>68.4</b>                        |
| <b>Operating income</b>                                     | <b>35,618</b>   | <b>29.3%</b>                       | <b>31,857</b>   | <b>31.6%</b>                       |
| <b>Comprehensive financing cost:</b>                        |   |                                    |   |                                    |
| Interest income   | (3,127)   |                                    | (1,772)   |                                    |
| Interest expense  | 5,796   |                                    | 4,580   |                                    |
| Exchange loss, net  | 1,733   |                                    | 444   |                                    |
| Monetary gain, net  | (1,105)   |                                    | (1,530)   |                                    |
|   | 3,297   |                                    | 1,722   |                                    |
| <b>Income before income tax and employee profit sharing</b> | <b>32,321</b>   |                                    | <b>30,135</b>   |                                    |
| <b>Provisions for:</b>                                      |   |                                    |   |                                    |
| Income tax  | 9,436   |                                    | 10,597  |                                    |
| Employee profit sharing                                     | 2,250   |                                    | 2,056   |                                    |

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|   |                   |                   |
|---|-------------------|-------------------|
|   | 11,686            | 12,653            |
|   | <u>          </u> | <u>          </u> |
| Income before equity interest in net loss of affiliates and minority interest | 20,635            | 17,482            |
| Equity interest in net loss of affiliates                                     | (60)              | (78)              |
|   | <u>          </u> | <u>          </u> |
| Net income  | Ps. 20,575        | Ps. 17,404        |
|   | <u>          </u> | <u>          </u> |
| Distribution of net income:   |                   |                   |
| Majority interest   | Ps. 19,835        | Ps. 17,380        |
| Minority interest   | 740               | 24                |
|   | <u>          </u> | <u>          </u> |
| Net Income  | Ps. 20,575        | Ps. 17,404        |
|   | <u>          </u> | <u>          </u> |

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### *Local Service Revenues*

Revenues from local service in the first nine months of 2005 decreased by 0.6% compared to the same period in 2004. Without the local service revenue of Embratel, revenue from local service would have decreased by 4.2%. The decrease in Mexico was primarily due to lower real rates and a 0.8% decrease in local traffic due principally to competition from wireless and Internet service providers.

### *Domestic Long Distance Revenues*

Revenues from domestic long distance in the first nine months of 2005 increased by 74.6% compared to the same period of 2004. The increase was primarily due to the consolidation of long distance revenues amounting to Ps.15,559 million from Embratel and other subsidiaries outside Mexico. Despite a 6.9% increase in domestic long distance traffic in Mexico, revenue from domestic long distance service in Mexico decreased by 2.0% due to lower real rates and customer discounts.

### *International Long Distance Revenues*

Revenues from international long distance in the first nine months of 2005 increased by 22.4% compared to the same period in 2004. The increase was due to the consolidation of international long distance revenues amounting to Ps.2,782 million from Embratel and other subsidiaries outside Mexico. Without such revenue, there would have been a decrease in revenue of 3.7% due to lower settlement rates and the effect of inflation on other rates, partially offset by a 6.2% increase in outgoing minutes and 11.0% increase in incoming minutes.

### *Revenues from Interconnection*

Interconnection revenues represent the income earned in Mexico from the calling party pays service, as well as income earned from connecting local, long distance and cellular operators to our networks both in Mexico and outside Mexico. Revenues from interconnection in the first nine months of 2005 decreased by 4.6% compared to the same period in 2004. The decrease was offset partially by the inclusion of revenues from non-Mexican operations, in particular Embratel, without which revenues would have decreased by 8.8%. The decrease in Mexico was due to the decrease of the calling party pays rate and the interconnection rate we receive as a long distance operator, which was not fully offset by a 20.3% increase in cellular traffic, a 21.5% increase in traffic from other local and long distance operators and a 2.9% increase in calling party pays traffic.

In prior periods, interconnection revenue included revenue from Embratel's resale services (which amounted to Ps.1,413 million in the first nine months of 2005). Beginning with this report, we will present these revenues under domestic long distance and international long distance to be consistent with the reporting of our Mexican operations. For comparative purposes, we have reclassified revenues in prior periods to reflect this change.

### *Revenues from Corporate Networks*

Revenues from corporate networks for the first nine months of 2005 rose 59.0% compared to the same period in 2004. The increase was due to the consolidation of corporate network revenues from our non-Mexican operations, in particular Embratel. Revenues from corporate networks for our Mexican operations increased by 3.7% due to a 26.5% increase in line equivalents in operation and a 92.0% increase in port equivalents in operation, despite lower real rates.

*Revenues from Internet Services*

Revenues from Internet services for the first nine months of 2005 increased by 47.9% compared to the same period in 2004. The increase was due in part to the inclusion of revenue from non-Mexican operations, in particular Embratel, without which the increase would have been by 17.3%. The increase in Internet service revenues in Mexico was due principally to a 98.3% increase in the number of Infinitum (ADSL) accounts.

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### *Other Revenues*

The largest components of other revenues are sales of yellow pages advertising, telecommunications equipment and accessories and billing and collection services offered to third parties. Other revenues in the first nine months of 2005 increased by 2.0% compared to the same period in 2004. The increase was due to growth in non-Mexican other revenues. For our Mexican operations, other revenues decreased by 5.1%. The decline was due to lower revenues from the sale of telecommunications materials.

### *Costs of Sales and Services*

Costs of sales and services increased by 7.5% in the first nine months of 2005 compared to the same period in 2004 due to the consolidation of our non-Mexican operations. Costs of sales and services decreased by 3.3% for our Mexican operations for a variety of reasons, including lower costs for computers that we resell to customers in conjunction with Internet services, lower expenses for settlement rates (due to the decline in international settlement rates), pensions and seniority premiums, travel expenses, production of directories and insurance.

### *Commercial, Administrative and General Expenses*

Commercial, administrative and general expenses increased by 31.9% in the first nine months of 2005 compared to the same period in 2004 due to the inclusion of expenses from our non-Mexican operations. Expenses for our Mexican operations decreased by 1.1% compared to the same period in 2004 due to reductions in advertising expenses, lower contributions to Social Security (IMSS) and lower costs of prepaid cards.

### *Transport and Interconnection*

Costs from interconnection include payments we make in Mexico, principally to cellular carriers under calling party pays, and costs from transport include fees paid by our non-Mexican subsidiaries for the use of facilities to complete their calls in areas where they do not have a network. Total interconnection and transport costs increased by 69.0% in the first nine months of 2005 compared to the same period of 2004 due primarily to the inclusion of our non-Mexican operations. Interconnection costs for our Mexican operations decreased by 10.6% compared to the same period in 2004, due to the 10% reduction in the calling party pays rate, the main component of this item.

### *Depreciation and Amortization*

Depreciation and amortization increased by 9.4% in the first nine months of 2005 compared to the same period in 2004 due to the inclusion of our non-Mexican operations, principally Embratel. For our Mexican operations, depreciation decreased by 10.6% compared to the same period in 2004 due to a decrease in the amount of our depreciable assets, reflecting declining equipment prices and the fact that the rate of Mexican inflation exceeded the rate of devaluation of the peso in 2005.

*Operating Income*

Operating income increased by 11.8% during the first nine months of 2005 compared to the same period in 2004 due to a 20.8% increase in revenues, which reflects the inclusion of Embratel. Our operating margin decreased to 29.3% during the first nine months of 2005 from 31.6% for the same period in 2004 due to a lower operating margin for Embratel.

*Comprehensive Financing Cost*

For the first nine months of 2005, comprehensive financing cost was Ps.3,297 million, compared to Ps.1,722 million for the same period in 2004. The changes in each component were as follows:

Interest income increased by 76.5% due to the inclusion of interest income of Embratel, higher interest rates in Mexico and abroad and a higher average level of interest-bearing assets.



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Interest expense increased by 26.6% due to the inclusion of the interest expense related to the debt of Embratel, higher interest rates in Mexico and abroad and our higher level of indebtedness.

Net exchange loss rose by 290.3% due to greater losses in 2005 on hedges on our U.S. dollar liabilities. During the first nine months of 2005, both the peso and the real appreciated against the dollar, producing an exchange of gain. However, because we had hedged our exposure to the dollar, this gain was more than offset by losses on our hedges.

The net gain in monetary position in the first nine months of 2005 decreased by 27.8% compared to the same period in 2004 due to lower levels of inflation in 2005.

### *Income Tax and Employee Profit Sharing*

The combined rate of provisions for income tax and employee profit-sharing in the first nine months of 2005 was 36.2% compared to 42.0% for the same period in 2004. This difference is principally due to a reduction in the statutory rate of the Mexican corporate income tax from 33.0% in 2004 to 30.0% in 2005 and a recognition of deferred tax assets resulting from our provisions for employee profit sharing beginning in 2005 due to a change in the Mexican income tax law that now allows the deduction of these provisions for tax purposes.

### *Net Income*

Net income increased by 18.2% during the first nine months of 2005 compared to the same period in 2004 due to an increase in operating income and lower income taxes, which were partly offset by an increase in comprehensive financing cost.

### **Capital Expenditures**

Our capital expenditures were Ps.14,628 million (approximately U.S.\$1,331 million) in the first nine months of 2005, and we anticipate that our total capital expenditures for 2005 will be consistent with our budget of Ps.22.9 billion (approximately U.S.\$2.1 billion). For 2006, we anticipate that our capital expenditures will be approximately Ps.23.0 billion (approximately U.S.\$2.1 billion). Our budgeted amount excludes any other investments we may make in other companies. For subsequent years, our capital expenditures will depend on the state of the Mexican economy and market conditions.

### **Indebtedness**

At September 30, 2005, we had total indebtedness of Ps.92,127 million (approximately U.S.\$8,491 million), an increase of 9.6% compared to September 30, 2004. This increase is due primarily to our issuance of U.S.\$950 million principal amount of 4.75% notes due 2010 and U.S.\$800 million principal amount of 5.50% notes due 2015 in the first quarter of 2005, partly offset by our prepayment of approximately U.S.\$700 million of debt of Embratel and our repurchase of U.S.\$337 million principal amount of our U.S.\$1.5 billion principal amount of notes due 2006. Of our total indebtedness at September 30, 2005, 17.6% was short term, 90.8% was in foreign currency (15.6% taking into account hedges) and 52.4% carried a fixed rate (69.7% taking into account swaps). As of September 30, 2005, we had entered into interest rate swaps of Ps.15,900 million, which yielded a new average fixed rate of 9.0%, and currency hedges of approximately U.S.\$6.4 billion, 94% of which hedges pesos to

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U.S. dollars and the remaining portion of which hedges reais to U.S. dollars.

For information regarding additional indebtedness incurred in the fourth quarter of 2005, see Capitalization.

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### **Share Purchase Program**

We have continued our share purchase program. In 2005, we purchased 1,577.6 million L shares for an aggregate consideration of Ps.16,927 million (historical) and 6.2 million A shares for Ps.66 million (historical). In 2004, we purchased 1,415.7 million L shares for an aggregate consideration of Ps.13,482 million (historical) and 3.4 million A shares for Ps.32 million (historical).

For comparative purposes, the above figures give retroactive effect to the two-for-one stock split of our shares that became effective on May 25, 2005.

### **Our Rates in Mexico**

In January 2006, we announced that we would not increase rates for any of our services in Mexico during 2006. Cofetel reduced the interconnection fee for calling party pays by 10% for 2005, to Ps.2.25 per minute from Ps.2.50 per minute in 2004. This fee has been further reduced by 10% in 2006 and will be reduced an additional 10% in 2007.

### **Recent Developments**

#### ***Sale to Embratel of Telmex do Brasil and Interest in Net***

In October 2005, we transferred to Embratel 100% of the capital stock of Telmex do Brasil and our 37.1% equity interest in Net in exchange for new common shares of Embratel. As a result, we own 97.3% of the voting stock and 45.4% of the non-voting stock of Embratel (72.3% of the total capital stock).

#### ***Syndicated Bank Facility***

On October 20, 2005, we entered into a new facility that replaced our U.S.\$2.425 billion syndicated bank facility obtained in July 2004. Under the new facility, we agreed to pay a smaller margin above LIBOR and increased the total loan amount to U.S.\$2.5 billion in two tranches, one for U.S.\$1.5 billion maturing in 2009 and one for U.S.\$1.0 billion maturing in 2011.

#### ***Embratel Acquisition of PrimeSys***

In November 2005, through its principal operating subsidiary, Embratel acquired from Portugal Telecom do Brasil S.A. 100% of the capital stock of Primesys Soluções Empresariais S.A., or PrimeSys, for R\$251 million (approximately Ps.1,202 million using the exchange rate of

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R\$0.2089 to Ps.1.00, based on the real to U.S. dollar and U.S. dollar to peso exchange rates reported by the Central Bank of Brazil and the Banco de México, respectively, for November 30, 2005). PrimeSys is a Brazilian provider of high level value added services, such as net integration and outsourcing.

### *Telmex Acquisition of Interest in 2Wire*

In December 2005, we agreed together with Alcatel USA Marketing, Inc., or Alcatel, and SBC International, Inc., or AT&T, to acquire an aggregate 51% interest in the capital stock of 2Wire, Inc., or 2Wire. 2Wire is an equipment and services supplier for broadband networking that develops integrated solutions to deliver broadband service and content throughout the home or small office. 2Wire also offers service providers with a platform to deliver and manage Internet, telephony, entertainment, and other enhanced broadband application services. We will acquire an approximate 18.5% interest in 2Wire for approximately U.S.\$88 million, and AT&T will pay us approximately U.S.\$26 million for the right to acquire from us an approximate 5.5% interest in 2Wire in the future upon the satisfaction of certain conditions. The transaction is expected to close during January 2006.

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**Exhibit 1**

**TELÉFONOS DE MÉXICO, S.A. DE C.V.**

**INDEX TO UNAUDITED CONDENSED**

**CONSOLIDATED INTERIM FINANCIAL STATEMENTS**

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**Table of Contents****TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED STATEMENTS OF INCOME****(In thousands of Mexican pesos, except earnings per share, with purchasing power at September 30, 2005)**

|  | Nine-month periods ended September 30, |                    |   |
|--|--|--------------------|---|
|  | 2005                                   | 2004               | 2005  |
|  |  |                    | Millions of U.S.<br>dollars,<br>except<br>for earnings<br>per share |
| Operating revenues:  |  |                    |   |
| Local service  | P. 43,385,915                          | P. 43,632,250      | \$ 3,999  |
| Domestic long-distance service   | 28,525,442                             | 16,335,644         | 2,629   |
| International long-distance service  | 10,051,072                             | 8,214,027          | 926   |
| Interconnection service  | 13,758,260                             | 14,421,646         | 1,268   |
| Corporate networks   | 13,918,299                             | 8,753,332          | 1,283   |
| Internet   | 8,107,260                              | 5,482,754          | 747   |
| Other  | 3,959,359                              | 3,881,111          | 366   |
|  | <u>121,705,607</u>                     | <u>100,720,764</u> | <u>11,218</u>   |
| Operating costs and expenses:  |  |                    |   |
| Cost of sales and services   | 24,960,011                             | 23,211,562         | 2,301   |
| Commercial, administrative and general expenses  | 20,499,835                             | 15,543,931         | 1,889   |
| Transport and interconnection  | 21,781,551                             | 12,885,153         | 2,008   |
| Depreciation and amortization (includes P. 17,442,566 in 2005 and P. 15,748,367 in 2004, not included in cost of sales and services) | 18,846,808                             | 17,223,363         | 1,737   |
|  | <u>86,088,205</u>                      | <u>68,864,009</u>  | <u>7,935</u>  |
| Operating income   | <u>35,617,402</u>                      | <u>31,856,755</u>  | <u>3,283</u>  |
| Comprehensive financing cost:  |  |                    |   |
| Interest income  | (3,126,715)                            | (1,772,279)        | (288)   |
| Interest expense   | 5,795,655                              | 4,580,312          | 534   |
| Exchange loss, net   | 1,733,202                              | 444,356            | 160   |
| Monetary gain, net   | (1,105,385)                            | (1,530,152)        | (102)   |
|  | <u>3,296,757</u>                       | <u>1,722,237</u>   | <u>304</u>  |
| Income before income tax and employee profit sharing   | <u>32,320,645</u>                      | <u>30,134,518</u>  | <u>2,979</u>  |
| Provisions for :   |  |                    |   |
| Income tax (Note 12)   | 9,435,622                              | 10,596,201         | 870   |
| Employee profit sharing  | 2,250,302                              | 2,056,342          | 207   |

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|  |               |               |          |
|--|---------------|---------------|----------|
|  | 11,685,924    | 12,652,543    | 1,077    |
| Income before equity interest in net loss of affiliates              | 20,634,721    | 17,481,975    | 1902     |
| Equity interest in net loss of affiliates                            | (59,584)      | (77,702)      | (6)      |
| Net income   | P. 20,575,137 | P. 17,404,273 | \$ 1,896 |
| Distribution of net income:  |               |               |          |
| Majority interest  | P. 19,835,418 | P. 17,380,148 | \$ 1,828 |
| Minority interest  | 739,719       | 24,125        | 68       |
|  | P. 20,575,137 | P. 17,404,273 | \$ 1,896 |
| Weighted average common shares outstanding (in millions) (Note 11) : |               |               |          |
| Basic  | 23,084        | 23,960        | 23,084   |
| Diluted  | 23,084        | 24,614        | 23,084   |
| Majority net income per share:                                       |               |               |          |
| Basic  | P. 0.859      | P. 0.725      | \$ 0.079 |
| Diluted  | 0.859         | P 0.724       | \$ 0.079 |
| Cash dividends paid per share (nominal amounts)                      | P. 0.360      | P. 0.495      | \$ 0.033 |

The accompanying notes are an integral part of these financial statements.

**Table of Contents****TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES****CONDENSED CONSOLIDATED BALANCE SHEETS****(In thousands of Mexican pesos with purchasing power at September 30, 2005)**

|   | September 30,<br>2005<br>Unaudited | December 31,<br>2004<br>(Note 1) | Millions of U.S.<br>dollars<br>September 30,<br>2005 |
|---|------------------------------------|----------------------------------|--|
| <b>ASSETS</b>   |                                    |                                  |  |
| Current assets:   |                                    |                                  |  |
| Cash and cash equivalents   | P. 27,407,874                      | P. 20,872,085                    | \$ 2,526   |
| Marketable securities and instruments available for sale (Note 2) | 52,260                             | 6,257,598                        | 5  |
| Accounts receivable, net (Note 3)                                 | 32,237,302                         | 30,972,480                       | 2,971  |
| Inventories for sale, net   | 900,036                            | 1,380,175                        | 83   |
| Prepaid expenses  | 1,715,109                          | 2,028,926                        | 158  |
| <b>Total current assets</b>                                       | <b>62,312,581</b>                  | <b>61,511,264</b>                | <b>5,743</b>   |
| Plant, property and equipment, net (Note 4)                       | 150,586,108                        | 154,754,976                      | 13,880   |
| Inventories, primarily for operation of the telephone plant, net  | 2,495,926                          | 2,225,806                        | 230  |
| Net projected asset   | 22,990,916                         | 26,088,932                       | 2,119  |
| Deferred taxes (Note 12)  | 5,853,697                          | 5,426,573                        | 540  |
| Goodwill, net (Note 5)  | 7,258,081                          | 3,851,748                        | 669  |
| Other assets  | 5,374,035                          | 4,059,319                        | 495  |
| <b>Total assets</b>   | <b>P. 256,871,344</b>              | <b>P. 257,918,618</b>            | <b>\$ 23,676</b>                                     |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                        |                                    |                                  |  |
| Current liabilities:  |                                    |                                  |  |
| Short-term debt and current portion of long-term debt (Note 6)    | P. 16,186,965                      | P. 13,434,587                    | \$ 1,492   |
| Accounts payable (Note 7)   | 16,705,449                         | 18,322,220                       | 1,540  |
| Accrued liabilities   | 9,696,839                          | 8,438,374                        | 894  |
| Taxes payable   | 2,780,023                          | 7,396,220                        | 256  |
| Deferred credits  | 2,966,697                          | 2,104,686                        | 273  |
| <b>Total current liabilities</b>                                  | <b>48,335,973</b>                  | <b>49,696,087</b>                | <b>4,455</b>   |
| Long-term debt (Note 6)   | 75,940,300                         | 78,245,306                       | 6,999  |
| Labor obligations   | 1,989,440                          | 1,755,959                        | 183  |
| Deferred taxes (Note 12)  | 15,651,414                         | 18,431,103                       | 1,443  |
| <b>Total liabilities</b>  | <b>141,917,127</b>                 | <b>148,128,455</b>               | <b>13,080</b>  |
| Stockholders' equity (Note 11):                                   |                                    |                                  |  |
| Capital stock   | 27,555,370                         | 28,511,451                       | 2,540  |
| Premium on sale of shares   | 19,093,240                         | 19,093,240                       | 1,760  |
| Retained earnings :   |                                    |                                  |  |
| Prior years   | 102,048,135                        | 87,402,291                       | 9,406  |
| Net income  | 19,835,418                         | 27,997,039                       | 1,828  |



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|  |                             |                             |                             |
|--|-----------------------------|-----------------------------|-----------------------------|
|  | 121,883,553                 | 115,399,330                 | 11,234                      |
| Accumulated other comprehensive income     | (65,904,349)                | (67,425,700)                | (6,074)                     |
|  | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Total majority stockholders' equity        | 102,627,814                 | 95,578,321                  | 9,460                       |
| Minority interest                          | 12,326,403                  | 14,211,842                  | 1,136                       |
|  | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Total stockholders' equity                 | 114,954,217                 | 109,790,163                 | 10,596                      |
|  | <u>                    </u> | <u>                    </u> | <u>                    </u> |
| Total liabilities and stockholders' equity | P. 256,871,344              | P. 257,918,618              | \$ 23,676                   |
|  | <u>                    </u> | <u>                    </u> | <u>                    </u> |

The accompanying notes are an integral part of these financial statements.

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**Table of Contents****TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES****UNAUDITED CONDENSED CONSOLIDATED****STATEMENTS OF CHANGES IN FINANCIAL POSITION****(In thousands of Mexican pesos with purchasing power at September 30, 2005)**

|   | Nine-month periods ended September 30, |                     |                |
|---|--|---------------------|----------------|
|   | Millions of U.S.                       |                     |                |
|   | dollars                                |                     |                |
|   | 2005                                   | 2004                | 2005           |
| <b>Operating activities:</b>  |  |                     |                |
| Net income  | P. 20,575,137                          | P. 17,404,273       | \$ 1,896       |
| Add (deduct) items not requiring the use of resources:                                    |  |                     |                |
| Depreciation and amortization   | 18,846,808                             | 17,223,363          | 1,737          |
| Deferred taxes  | (2,104,808)                            | (498,528)           | (194)          |
| Equity interest in net loss of affiliates   | 59,584                                 | 77,702              | 6              |
| Other   | 186,004                                |                     | 17             |
| Marketable securities   | 281,173                                | 7,043,722           | 26             |
| Changes in operating assets and liabilities   | (2,393,518)                            | 1,407,800           | (221)          |
|   | <u>35,450,380</u>                      | <u>42,658,332</u>   | <u>3,267</u>   |
| <b>Financing activities:</b>  |  |                     |                |
| New loans   | 22,046,650                             | 33,382,246          | 2,032          |
| Repayment of loans  | (16,608,110)                           | (29,646,548)        | (1,531)        |
| Effect of exchange rate differences and inflation on debt                                 | (4,991,168)                            | (2,213,644)         | (460)          |
| Decrease in capital stock and retained earnings due to purchase of Company's own shares   | (11,257,305)                           | (11,324,389)        | (1,037)        |
| Conversion of debt instruments to shares  |  | 6,881,271           |                |
| (Decrease) increase in capital stock and retained earnings due to stock options exercised | (246,119)                              | 30,824              | (23)           |
| Minority interest   | 996,291                                |                     | 92             |
| Cash dividends paid   | (6,358,688)                            | (6,242,105)         | (586)          |
|   | <u>(16,418,449)</u>                    | <u>(9,132,345)</u>  | <u>(1,513)</u> |
| <b>Investing activities:</b>  |  |                     |                |
| Plant, property and equipment   | (15,149,024)                           | (11,265,139)        | (1,396)        |
| Instruments available for sale  | 7,049,150                              | (7,194,652)         | 650            |
| Inventories   | (268,123)                              | (689,695)           | (25)           |
| Subsidiaries and affiliated companies   | (3,633,957)                            | (9,655,060)         | (335)          |
| Initial cash from companies acquired  |  | 4,392,525           |                |
| Other   | (494,188)                              |                     | (46)           |
|   | <u>(12,496,142)</u>                    | <u>(24,412,021)</u> | <u>(1,152)</u> |
| Net increase in cash and cash equivalents   | 6,535,789                              | 9,113,966           | 602            |

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|  |                      |                      |                 |
|--|----------------------|----------------------|-----------------|
| Cash and cash equivalents at beginning of period | <u>20,872,085</u>    | <u>10,911,830</u>    | <u>1,924</u>    |
| Cash and cash equivalents at end of period       | <u>P. 27,407,874</u> | <u>P. 20,025,796</u> | <u>\$ 2,526</u> |

The accompanying notes are an integral part of these financial statements.

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|   |               |               |               |                |                |                 |                |               |               |                |
|---|---------------|---------------|---------------|----------------|----------------|-----------------|----------------|---------------|---------------|----------------|
| Effect of translation of foreign entities, net                  |               |               |               |                |                | 1,712,642       | 1,712,642      | 1,216,916     | 2,929,558     | 2,929,558      |
| Deficit from holding non-monetary assets, net of deferred taxes |               |               |               |                |                | (1,881,442)     | (1,881,442)    | (771,371)     | (2,652,813)   | (2,652,813)    |
| Comprehensive income  |               |               |               |                |                |                 |                |               | P. 21,904,270 |                |
| Balances at September 30, 2005 (Note 11)                        | P. 27,555,370 | P. 19,093,240 | P. 18,935,279 | P. 102,948,274 | P. 121,883,553 | P. (65,904,349) | P. 102,627,814 | P. 12,326,403 |               | P. 114,954,217 |

The accompanying notes are an integral part of these financial statements.

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**TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

**(In thousands of Mexican pesos with purchasing power at September 30, 2005)**

**1. Significant Accounting Policies**

*a) Basis of presentation:*

The accompanying unaudited condensed consolidated financial statements are presented on the same basis of accounting as described in the audited financial statements of Teléfonos de México, S.A. de C.V. and its subsidiaries (collectively the Company or TELMEX ) as of December 31, 2004 and for each of the three years in the period ended December 31, 2004 (the audited financial statements), and have been prepared in accordance with generally accepted accounting principles for interim financial information. Accordingly, they do not include all the information and footnotes required by generally accepted accounting principles for complete financial statements. In the opinion of management, all adjustments (consisting of normal recurring accruals) considered necessary for a fair presentation of financial information have been included.

The condensed consolidated balance sheet as of December 31, 2004 has been derived from the financial statements at that date, but does not include all of the information and footnotes required by generally accepted accounting principles for complete financial statements.

*b) Consolidation:*

The consolidated financial statements include the accounts of Teléfonos de México, S.A. de C.V. and its subsidiaries, all of which are wholly owned, except for Embratel, Chilesat and Techtel, in which the Company holds voting interests of 95.1%, 99.5% and 93.4%, respectively (90.3%, 99.3% and 83.4%, respectively, at December 31, 2004), respectively (see Note 5). At September 30, 2005, the related minority interest recognized in stockholders' equity is P. 12,326,403 (P. 14,211,842 at December 31, 2004). All the companies operate in the telecommunications sector or they provide services to companies operating in this sector.

All significant intercompany accounts and transactions have been eliminated in consolidation.

*c) Recognition of the effects of inflation on financial information:*

All financial statements presented herewith were restated to constant pesos as of September 30, 2005. The September 30, 2005 restatement factor applied to the financial statements at December 31, 2004 and September 30, 2004 was 1.0182 and 1.0363, which represent the rate of inflation from December 31, 2004 and September 30, 2004 up to September 30, 2005, respectively, based on an estimated Mexican National Consumer Price Index.

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The condensed consolidated balance sheet as of December 31, 2004 has been derived from the audited financial statements at that date, which were presented in constant pesos as of December 31, 2004.

*d) Basis of translation of financial statements of foreign subsidiaries:*

The financial statements of the subsidiaries located abroad were translated as follows:

The financial statements as reported by the subsidiaries abroad were adjusted to conform to accounting principles accepted in Mexico. Such conversion includes, among other areas, the recognition of the effects of inflation as required by Mexican GAAP, using restatement factors of each country.

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**TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**(In thousands of Mexican pesos with purchasing power at September 30, 2005)**

All balance sheet amounts, except for stockholders' equity, were translated at the prevailing exchange rate at the date of the latest balance sheet presented; stockholders' equity accounts were translated at the prevailing exchange rate at the time capital contributions were made and earnings were generated. The statement of income amounts were translated at the prevailing exchange rate at the end of the reporting period.

Translation differences are included in the caption *Effect of translation of foreign entities* and are included in stockholders' equity as part of the caption *Other comprehensive income*.

Under Mexican GAAP, the financial statements of foreign subsidiaries and affiliates for periods prior to the most recent period are translated following the guidelines of Bulletin B-15. This bulletin requires that the financial statements of foreign subsidiaries and affiliates for periods prior to the most recent period be translated into constant Mexican pesos by restating the balances to constant units in the local currency using the inflation rate of the country in which the subsidiary or affiliate is located before being translated into Mexican pesos at the rate of exchange at the end of the reporting period.

In the Company's balance sheet as of December 31, 2004 and in the financial statements for the nine-month period ended September 30, 2004, such restatements were made based on the inflation in Mexico because the Company's investments in foreign subsidiaries and affiliates were not material in any of these periods.

*e) Goodwill:*

Goodwill represents the excess of cost over the fair value of the net assets of subsidiaries and affiliates acquired and until December 31, 2004 was being amortized using the straight-line method over a range of five to twenty years.

*f) New accounting pronouncements:*

The new accounting pronouncements, which went into effect in 2005, are as follows:

***Business acquisitions***

In May 2004, Mexican Accounting Principles Bulletin B-7, *Business Acquisitions* was issued. The adoption of Bulletin B-7 became compulsory on January 1, 2005. This Bulletin addresses the financial accounting and reporting for business and entity acquisitions and requires that all business acquisitions be accounted for using the purchase method. It also eliminates the amortization of goodwill. In accordance with this new



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pronouncement, an acquisition of a minority interest is considered a transaction between entities under common control and requires that any difference between the purchase price paid and the carrying value of the net assets acquired be recognized as a capital transaction.

The adoption of this accounting pronouncement gave rise to a decrease in the Company's operating expenses for 2005 of approximately P. 153,000, derived from the non-amortization of goodwill, and to a cancellation of negative goodwill of P.10,466 derived from ATT's assets acquired in 2004. Had the Company adopted this new pronouncement in 2004, net income for the nine-month period ended September 30, 2004 would have increased by P.90,463.

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**TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**(In thousands of Mexican pesos with purchasing power at September 30, 2005)**

***Financial instruments***

In April 2004, Bulletin C-2 was amended. The amendments to Bulletin C-2 are effective January 1, 2005, however, early adoption was encouraged. The amendments change the rules for valuing instruments classified as *available-for-sale* at their fair value and, unlike the previous Bulletin C-2, require the recognition of such instruments at fair value in stockholders' equity, until such instruments are sold. The amended Bulletin C-2 also provides the requirements and rules for the accounting treatment of transfers between financial asset categories. The amendments are also more precise in establishing the guidelines for the accounting treatment to be given to impairment in the fair value of financial instruments. Furthermore, the amended bulletin requires that such instruments be classified as either short-term or long-term and clarifies the rules for presenting in the statement of changes in financial position changes associated with the purchase, sale and maturity of financial instruments. Finally, the amendments broaden the disclosure rules established under Bulletin C-2.

The Company adopted in 2004 the requirements of this new accounting pronouncement, which gave rise to a charge to stockholders' equity, as part of comprehensive income of P. 2,120,203.

***Derivative financial instruments and hedging activities***

In order to decrease financial costs, the Company uses derivatives that have been designated and qualified as hedges and are designated in Telmex either as fair value hedges (forwards) or cash flow hedges (interest rate swaps), and both are based on covered risk. Until December 31, 2004 fair value hedges were valued following the same criteria applied to covered liabilities and for cash flow hedges the Company only recognized positive and negative flows in its results, according to the agreed conditions in the respective contracts.

Since January 1, 2005 due to the adoption of the new Bulletin C-10 *Accounting for Derivatives and Hedging* issued by the Mexican Institute of Public Accountants (MIPA) in April 2004, policies related to these hedges were modified. Regarding fair value hedges, the gain or loss resulting from changes in fair value is recognized in the results for the period in which it occurs, together with the gain or loss on the hedged asset or liability.

In the case of cash flow hedges, the cash position of the gains and losses of these hedges are recognized in the account of integral income in stockholders' equity and the ineffectiveness position is recognized immediately in the results of the period. The effectiveness of hedges is determined at the moment that they are designated as hedges and are measured on a monthly basis. Hedges are considered highly effective where changes in fair value or cash flow in the primary position are offset on a periodic or an accrued basis from the changes in the fair value or cash flow of hedges between a rank of 80% and 125%. The effect of the adoption of this new Bulletin represented a credit in net income of P.124,033, net of deferred taxes, and a credit in stockholders' equity of P.310,799, net of deferred taxes. Had the Company adopted this new pronouncement in 2004, assuming that the criteria for hedge accounting had been met, net income for the nine-month period ended September 30, 2004 would have decreased by P.54,835.

*Labor Obligations*

In January 2004, the revised Mexican Accounting Principles Bulletin D-3, *Labor Obligations* was issued. The revised bulletin establishes the overall rules for the valuation, presentation and disclosure of so-called other post-retirement benefits and the reduction and early extinguishment of such benefits, thus nullifying the provisions of Circular 50 *Interest Rates Applicable in the Valuation of Labor Obligations and Supplementary Application of Accounting Principles Related to Labor Obligations*, issued by the MIPA. Bulletin D-3 also provides rules applicable to *Employee termination payments*. The Company

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**Table of Contents****TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(In thousands of Mexican pesos with purchasing power at September 30, 2005)**

did not adopt these changes as they were immaterial to the consolidated financial statements. Had the Company adopted this new pronouncement, net income for the nine-month period ended September 30, 2005 would have decreased by P.15,890.

**Pro Forma Financial Data**

The following pro forma unaudited combined financial data for the nine-month periods ended September 30, 2005 and 2004 is based on the Company's historical financial statements, adjusted to give effect to the new accounting pronouncements described above.

|  | <b>Pro forma unaudited combined<br/>Nine-month periods ended<br/>September 30,</b> |             |
|--|--|-------------|
|  | <b>2005</b>  | <b>2004</b> |
| Majority net income                    | 19,819,528   | 17,415,776  |
| Earnings per share (in Mexican Pesos): |  |             |
| Basic                                  | 0.859  | 0.727       |
| Diluted                                | 0.859  | 0.725       |

*g) Convenience translation:*

United States dollar amounts as of September 30, 2005 shown in the unaudited condensed consolidated financial statements have been included solely for the convenience of the reader and are translated from Mexican pesos with purchasing power as of September 30, 2005, as a matter of mathematical computation only, at an exchange rate of P. 10.8495 to U.S.\$1.00, the September 30, 2005 exchange rate. Such translations should not be construed as a representation that the peso amounts have been or could be converted into U.S. dollar at this or any other rate.

*h) Reclassifications:*

Certain amounts shown in the 2004 financial statements as originally issued have been reclassified for uniformity of presentation with 2005.

**2. Marketable Securities Held for Trading Purposes and Instruments Available for Sale**

An analysis of the Company's investments in financial instruments at September 30, 2005 and December 31, 2004, is as follows:

|   | At September 30, 2005 |                  | At December 31, 2004 |                     |
|---|-----------------------|------------------|----------------------|---------------------|
|   | Cost                  | Market value     | Cost                 | Market value        |
| <b><i>Marketable securities held for trading purposes</i></b> |                       |                  |                      |                     |
| Shares  | P. 414,307            | P. 286           | P. 631,176           | P. 213,448          |
| Corporate bonds   | 46,326                | 51,974           | 61,359               | 119,985             |
|   | <u>460,633</u>        | <u>52,260</u>    | <u>692,535</u>       | <u>333,433</u>      |
| <b><i>Instruments available for sale</i></b>                  |                       |                  |                      |                     |
| MCI shares  |                       |                  | 7,049,150            | 5,924,165           |
|   | <u>P. 460,633</u>     | <u>P. 52,260</u> | <u>P. 7,741,685</u>  | <u>P. 6,257,598</u> |

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**Table of Contents****TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(In thousands of Mexican pesos with purchasing power at September 30, 2005)*****Marketable securities held for trading purposes***

At September 30, 2005 and December 31, 2004, net unrealized losses on marketable securities were P. 408,373 and P. 359,102, respectively. In 2005, the realized gain on the sale of corporate bonds was P. 18,111. The realized loss on the sale of shares in 2005 was P. 64,285.

On April 21, 2004, the Company converted P. 7,049,150 (U.S.\$597.9 million) (market value) in bonds issued by MCI Inc. (MCI) (nominal value of U.S.\$1,759 million) to 25.6 million common MCI shares, which were classified as available for sale. MCI is a U.S.-based telecommunications company that emerged from Chapter 11 proceedings under the U.S. bankruptcy code. The conversion of MCI bonds gave rise to a realized gain of P. 2,052,569, which corresponded to the difference between the original cost and the market value of the bonds at the time of their conversion.

***Instruments available for sale***

On April 9, 2005, TELMEX and other related entities entered into an agreement to sell MCI shares to Verizon Communications, Inc. (Verizon). On May 17, 2005 Verizon paid to TELMEX U.S.\$25.72 dollars in cash per share of MCI common stock for an aggregate cash consideration of P.7,712,882. In addition, TELMEX also has the right to receive from Verizon an additional cash payment to the extent the trading value of Verizon's common stock is greater than U.S.\$ 35.52 during a measurement period ending immediately prior to April 9, 2006. TELMEX recognized a gain on the sale of these instruments of P. 494,042 as a result of the sale of these shares, which was recognized in comprehensive financing income.

At December 31, 2004, the Company held 25.6 million MCI shares. The unrealized loss on these shares in 2004 was P. 1,124,985, which was recognized as a charge to stockholders' equity in comprehensive income. In the nine-month periods ended September 2005 and 2004, TELMEX received dividends from MCI in the amounts of P. 116,993 and P. 121,660, respectively, which were recognized in comprehensive income.

**3. Accounts Receivable**

Accounts receivable consist of the following:

|           | <b>September 30,<br/>2005</b> | <b>December 31,<br/>2004</b> |
|-----------|-------------------------------|------------------------------|
| Customers | P. 35,424,156                 | P. 34,487,303                |

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|                                 |                      |                      |
|---------------------------------|----------------------|----------------------|
| Net settlement receivables      | 2,646,664            | 2,525,621            |
| Related parties                 | 481,695              | 497,252              |
| Other                           | 4,250,487            | 5,067,939            |
|                                 | <u>42,803,002</u>    | <u>42,578,115</u>    |
| Less:                           |                      |                      |
| Allowance for doubtful accounts | 10,565,700           | 11,605,635           |
|                                 | <u>10,565,700</u>    | <u>11,605,635</u>    |
| Total                           | <u>P. 32,237,302</u> | <u>P. 30,972,480</u> |

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**Table of Contents****TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(In thousands of Mexican pesos with purchasing power at September 30, 2005)****4. Plant, Property and Equipment**

a) Plant, property and equipment consist of the following:

|  | <b>September 30,<br/>2005</b> | <b>December 31,<br/>2004</b> |
|--|-------------------------------|------------------------------|
| Telephone plant and equipment                                | P. 327,195,459                | P. 323,212,125               |
| Land and buildings   | 43,341,046                    | 41,917,955                   |
| Computer equipment and other assets                          | 55,587,166                    | 54,726,696                   |
|  | <u>426,123,671</u>            | <u>419,856,776</u>           |
| Less:  |                               |                              |
| Accumulated depreciation                                     | 283,788,450                   | 268,974,053                  |
| Net  | 142,335,221                   | 150,882,723                  |
| Construction in progress and advances to equipment suppliers | 8,250,887                     | 3,872,253                    |
| Total  | <u>P. 150,586,108</u>         | <u>P. 154,754,976</u>        |

b) Depreciation charged to operating costs and expenses in the nine-month periods ended September 30, 2005 and 2004 was P. 18,154,847 and P. 16,993,321, respectively.

**5. Investments****I. Investments in affiliates*****Technology and Internet (U.S. and Latin America)***

On June 21, 2005, the Company sold its 50% interest in Technology and Internet L.L.C. to Grupo Condumex, S.A. de C.V., a company under common control, for P. 42,812, which was lower than the carrying amount, and accordingly a charge of P. 95,918 was made to retained earnings.



*NET (Brazil)*

TELMEX acquired in 2005 its interest in Net Serviços de Comunicação S.A. (Net), the largest cable television operator in Brazil, pursuant to agreements with Globo Comunicações e Participações S.A., Distel Holding S.A. and Roma Participações Ltda. (together, Globo). After a series of transactions, TELMEX owns (a) 49% of the voting interests and all of the non-voting interests in GB Empreendimentos e Participações S.A., or GB, a company that owns 51% of the voting shares of Net and (b) 37.4% of the voting and 7.7% of the non-voting shares of Net. Globo owns the remaining 51% of the voting interests in GB.

The total cost of these transactions was P. 3,397,087 (U.S.\$313 million). Telmex's total direct and indirect equity interest in Net is 37.1% (calculated by multiplying the shares of Net held by GB by our percentage equity interest in GB, and adding the shares we own directly in Net).

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This acquisition was recorded using the purchase method. An analysis of the purchase price of the net assets acquired based on fair value is as follows:

|                                   | Values at acquisition date |              |              |              |
|-----------------------------------|----------------------------|--------------|--------------|--------------|
|                                   | January 2005               | March 2005   | May 2005     | Total        |
| Current assets                    | P. 6,683,534               | P. 5,924,671 | P. 6,253,516 |              |
| Fixed assets                      | 3,664,163                  | 3,604,277    | 3,184,007    |              |
| <b>Less:</b>                      |                            |              |              |              |
| Current liabilities               | 8,948,132                  | 2,490,786    | 1,544,396    |              |
| Long-term liabilities             | 2,342,022                  | 6,086,658    | 5,755,371    |              |
| Fair value of net assets acquired | (942,457)                  | 951,504      | 2,137,756    |              |
| % of equity acquired              | 1.56%                      | 35.32%       | 0.23%        |              |
| Net assets acquired               | (14,702)                   | 336,071      | 4,917        | P. 326,286   |
| Amount paid                       | 221,221                    | 3,155,599    | 20,267       | 3,397,087    |
| Goodwill recorded                 | P. 235,923                 | P. 2,819,528 | P. 15,350    | P. 3,070,801 |

## Goodwill

The goodwill generated by the above-described acquisition at September 30, 2005 is subject to modifications once the Company finishes the analysis of the fair value of assets and liabilities acquired.

**II. Investments in subsidiaries*****Embrapar (Brazil)***

From March through May 2005, TELMEX subscribed P. 6,857,826 (U.S.\$611.5 million) to increase the capital stock of its subsidiary Embratel Participações S.A. (Embrapar), increasing its ownership to 95.1% of the voting shares and 63.9% of the outstanding shares (90.3% and 33.6% at December 31, 2004, respectively). Minority shareholders subscribed P.996,291 (U.S.\$88 million) in the same period.

On October 24, 2005 TELMEX contributed to Embrapar the total capital stock of Telmex do Brasil Ltda. (Telmex do Brasil) and its 37.1% interest in the capital stock of Net, increasing its ownership in Embrapar to 97.3% of the voting shares and 72.3% of the outstanding shares. The transaction was implemented through the merger of Atlantis Holdings do Brasil Ltda. and Latam do Brasil Participações S.A., companies which hold the participation in the capital stock of Telmex do Brasil and Net, respectively. The effect of this transaction will increase majority stockholders' equity by approximately P.1,300,000.

***Techtel (Argentina)***

On June 23, 2005, TELMEX exercised its right to acquire from Intelec, S.A. an additional interest of approximately 10% in Techtel LMDS Comunicaciones Interactivas, S.A. and Telstar (Techtel) for P.163,544 (U.S.\$15 million), increasing its ownership to 93.4% (83.4% at December 31, 2004). On December 27, 2005, TELMEX acquired the remaining 6.6% interest of Techtel from Intelec for P.106,845 (U.S.\$10 million).

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**TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES**

**NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

**(In thousands of Mexican pesos with purchasing power at September 30, 2005)**

**III. Subsequent events**

***Primesys (Brazil)***

On November 25, 2005, Empresa Brasileira de Telecomunicações S.A. (Embratel), subsidiary of Embrapar, acquired from Portugal Telecom do Brasil S.A. 100% of the capital stock of Primesys Soluções Empresariais S.A. (Primesys) for R\$251 million. Primesys provides high-value added services in Brazil, such as net integration and outsourcing.

***2Wire (U.S.)***

In December 2005, TELMEX agreed together with Alcatel USA Marketing, Inc., or Alcatel, and SBC International, Inc., or AT&T, to acquire an aggregate 51% interest in the capital stock of 2Wire, Inc., or 2Wire. 2Wire is an equipment and services supplier for broadband networking which develops integrated solutions to deliver broadband service and content throughout the home or small office. 2Wire also offers service providers a platform to deliver and manage Internet, telephony, entertainment, and other enhanced broadband application services. TELMEX will acquire an approximate 18.5% interest in 2Wire for U.S.\$87.8 million, and AT&T will pay to TELMEX U.S.\$26.05 million for the right to acquire from TELMEX an approximate 5.5% interest in 2Wire in the future upon the satisfaction of certain conditions. The transaction is expected to close during the first quarter of 2006.

**IV. Pro Forma Financial Data**

The following pro forma unaudited combined financial data for the nine-month periods ended September 30, 2005 and 2004 is based on the Company's historical financial statements, adjusted to give effect to (i) the Latin American subsidiaries acquired during 2004; and (ii) certain accounting adjustments related to the net fixed assets of the acquired companies. The pro forma adjustments assume that acquisitions were made at the beginning of 2004 and are based upon available information and other assumptions that management believes are reasonable.

The pro forma financial information data does not purport to represent what the effect on the Company's consolidated operations would have been had the transactions in fact occurred at the beginning of the year, nor are they intended to predict the Company's results of operations.

**Pro forma unaudited combined**

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|  | Nine-month periods ended<br>September 30, |                |
|--|---|----------------|
|  | 2005                                      | 2004           |
| Operating revenues                     | P. 122,647,242                            | P. 119,579,042 |
| Majority net income                    | 20,103,587                                | 16,018,551     |
| Earnings per share (in Mexican Pesos): |   |                |
| Basic                                  | 0.871                                     | 0.669          |
| Diluted                                | 0.871                                     | 0.668          |

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**Table of Contents****TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

(In thousands of Mexican pesos with purchasing power at September 30, 2005)

**6. Long-term Debt**

Long-term debt consists of the following:

|  | Weighted average  |                 |                         | Balance at            |                      |
|--|-------------------|-----------------|-------------------------|-----------------------|----------------------|
|  | interest rates at |                 | Maturities<br>from 2005 | September 30,<br>2005 | December 31,<br>2004 |
|  | Sep. 30<br>2005   | Dec. 31<br>2004 |                         |                       |                      |
| <b>Debt denominated in U.S. dollars:</b>             |                   |                 |                         |                       |                      |
| <b>Consolidated excluding Embratel:</b>              |                   |                 |                         |                       |                      |
| Senior notes (1) (2) (3)                             | 5.9%              | 6.7%            | 2015                    | P. 42,449,547         | P. 28,674,548        |
| Banks  | 4.8%              | 3.4%            | 2014                    | 34,701,133            | 38,012,338           |
| Suppliers credits                                    | 5.7%              | 3.8%            | 2022                    | 83,173                | 228,495              |
| Financial leases                                     | 5.4%              | 4.1%            | 2014                    | 576,085               | 1,204,977            |
| Mexican Government                                   |                   | 3.6%            |                         |                       | 52,815               |
| <b>Total</b>   |                   |                 |                         | <b>77,809,938</b>     | <b>68,173,173</b>    |
| <b>Debt of Embratel denominated in U.S. dollars:</b> |                   |                 |                         |                       |                      |
| Bonds  | 11.0%             | 11.0%           | 2008                    | 1,930,961             | 3,154,200            |
| Banks  | 5.5%              | 5.3%            | 2013                    | 3,290,517             | 5,620,374            |
| Suppliers credits                                    | 5.7%              | 8.4%            | 2005                    | 3,936                 | 75,402               |
| Financial leases                                     | 11.2%             | 13.6%           | 2006                    | 1,684                 | 72,885               |
| <b>Total</b>   |                   |                 |                         | <b>83,037,036</b>     | <b>77,096,034</b>    |
| <b>Debt denominated in Mexican Pesos:</b>            |                   |                 |                         |                       |                      |
| Domestic senior notes ( Certificados Bursátiles )    | 10.0%             | 9.9%            | 2012                    | 6,600,000             | 7,585,590            |
| Banks  | 9.4%              | 9.0%            | 2007                    | 1,300,000             | 1,323,660            |
| <b>Total</b>   |                   |                 |                         | <b>7,900,000</b>      | <b>8,909,250</b>     |
| <b>Debt denominated in Brazilian Reais:</b>          |                   |                 |                         |                       |                      |
| Banks  | 15.1%             | 15.0%           | 2008                    | 75,065                | 88,683               |
| Financial leases                                     | 19.7%             | 19.7%           | 2008                    | 16,141                | 13,187               |
| Commercial paper                                     |                   | 18.0%           |                         |                       | 4,321,059            |
| <b>Total</b>   |                   |                 |                         | <b>91,206</b>         | <b>4,422,929</b>     |
| <b>Debt denominated in other currencies:</b>         |                   |                 |                         |                       |                      |

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|   |      |      |      |                      |                      |
|---|------|------|------|----------------------|----------------------|
| Banks   | 5.1% | 5.4% | 2017 | 659,347              | 733,357              |
| Financial leases  | 8.4% | 8.3% | 2027 | 192,898              | 204,413              |
| Suppliers credits   | 2.0% | 2.0% | 2022 | 246,778              | 313,910              |
| <b>Total</b>  |      |      |      | <u>1,099,023</u>     | <u>1,251,680</u>     |
| Total debt  |      |      |      | 92,127,265           | 91,679,893           |
| Less short-term debt and current portion of long-term debt: |      |      |      |                      |                      |
| Excluding Embratel  |      |      |      | 15,083,214           | 4,908,766            |
| Embratel  |      |      |      | 1,103,751            | 8,525,821            |
| Total short-term debt and current portion of long-term debt |      |      |      | <u>16,186,965</u>    | <u>13,434,587</u>    |
| Long-term debt  |      |      |      | <u>P. 75,940,300</u> | <u>P. 78,245,306</u> |

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The above-mentioned rates are subject to variances in international and local rates and do not include the effect of the Company's agreement with certain lenders to gross-up Mexican taxes withheld. The Company's weighted average cost of borrowed funds at September 30, 2005 (including interest, fees, effect of interest rate swaps and gross-up for Mexican taxes withheld) was approximately 6.3% without including Embratel (6.3% at December 31, 2004) and 6.6% including Embratel (7.2% at December 31, 2004).

(1) On January 26, 2001, TELMEX issued senior notes for U.S.\$1,000 million, maturing in 2006 and bearing 8.25% annual interest payable semiannually. Additionally, on May 8, 2001, TELMEX issued supplemental senior notes for U.S.\$500 million with similar characteristics. In the nine-month period ended September 30, 2005, the accrued interest on the bonds was P. 1,069,758 (P.1,161,112 in 2004).

(2) On November 19, 2003, TELMEX issued senior notes for U.S.\$1,000 million maturing in 2008 and bearing 4.50% annual interest payable semiannually. In the nine-month period ended September 30, 2005, the accrued interest on the bonds was P.393,318 (P. 415,440 in 2004).

(3) On January 27, 2005, TELMEX made a bond placement of U.S.\$ 1,300 million divided into two issuances of U.S.\$ 650 million each. The first placement matures in 2010 and bears 4.75% annual interest and the second matures in 2015 and bears 5.50% annual interest. Interest is payable semi-annually. On February 22, 2005 such placements were reopened and the bonds issued were increased to U.S.\$ 950 and U.S.\$ 800 million, respectively. In the nine-month period ended September 30, 2005, the accrued interest on the bonds was P. 682,698.

An analysis of the foreign currency denominated debt at September 30, 2005 is as follows:

|                  | <b>Foreign currency</b> | <b>Exchange rate at<br/>September 30,<br/>2005</b> |       | <b>Mexican peso</b>  |
|------------------|-------------------------|--|-------|----------------------|
|                  | <b>(in thousands)</b>   | <b>(in units)</b>                                  |       | <b>Equivalent</b>    |
| U.S. Dollars     | 7,653,537               | P.   | 10.85 | P. 83,037,050        |
| Brazilian Reais  | 18,679                  |  | 4.88  | 91,206               |
| Other currencies |                         |  |       | 1,099,009            |
| <b>Total</b>     |                         |  |       | <b>P. 84,227,265</b> |

At September 30, 2005, the Company has long-term lines of credit with certain foreign finance institutions. The unused portion of committed lines of credit at September 30, 2005, totaled approximately P.1,950,261, at a floating interest rate of approximately Libor plus 55 basis points at the time of use.





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Long-term debt maturities at September 30, 2005, are as follows:

| Year              | Amount (excluding<br>Embratel) | Embratel     | Total         |
|-------------------|--------------------------------|--------------|---------------|
| September 30 2006 | P. 816,966                     | P. 177,356   | P. 994,322    |
| 2007              | 25,311,878                     | 776,460      | 26,088,338    |
| 2008              | 16,967,441                     | 2,404,981    | 19,372,422    |
| 2009              | 6,455,467                      | 338,597      | 6,794,064     |
| 2010 and beyond   | 21,760,213                     | 930,941      | 22,691,154    |
| Total             | P. 71,311,965                  | P. 4,628,335 | P. 75,940,300 |

From January 1 through September 30, 2005, TELMEX repurchased its own bonds for a total of P. 3,817,256 (U.S.\$ 337 million) (nominal value). The acquired bonds were part of the U.S.\$ 1,500 million senior notes issued in 2001, which mature in January 2006. The difference between the repurchase price and the nominal value of the bonds was a premium paid of P. 166,199 (U.S.\$ 14.7 million), which was recognized in comprehensive financing cost.

At September 30, 2005, TELMEX has placed domestic senior notes ( Certificados Bursátiles ) for a total of P. 6,600,000 (P. 7,585,590 at December 31, 2004) under the P. 10,000,000 program authorized by the National Banking and Securities Commission (CNBV).

On September 30, 2005, TELMEX obtained the approval from the CNBV for a new issuance program of domestic long-term senior notes ( Certificados Bursátiles ) in the amount of P.10,000,000.

Some of the above-mentioned loans are subject to certain restrictive covenants with respect to maintaining certain financial ratios and selling a substantial portion of group assets, among others. At September 30, 2005, the Company has met all of these requirements.

From January 1 to September 30, 2005, the Company prepaid part of its outstanding debt held by several financial institutions, excluding the purchases of the Senior Notes due 2006, in the amount of approximately U.S.\$22 million, without paying any penalty.

On October 20, 2005, TELMEX signed an agreement to restructure the syndicated bank loan issued on July 15, 2004 of U.S.\$ 2,425 million (i) to improve the credit conditions and (ii) to increase the total amount up to U.S.\$ 2,500 million in two tranches, the first of U.S.\$ 1,500 million

due in 2009 and the second of U.S.\$ 1,000 million due in 2011.

### **Hedges**

As part of its currency hedging strategy, the Company (excluding Embratel) uses derivatives to minimize the impact of exchange rate fluctuations on U.S. dollar denominated transactions. During 2004, the Company entered into short-term foreign currency hedges, which at September 30, 2005, cover the exchange risk on recorded liabilities of U.S.\$ 6,005 million (U.S.\$ 3,220 million at December 31, 2004). In the nine-month period ended September 30, 2005, the Company recognized a charge to results of operations under these hedges of P. 4,669,857 (credit of P. 69,411 in 2004) corresponding to the fluctuation of the exchange rate.

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Also, our subsidiary Embratel used foreign currency swaps and forwards contracted with banks to protect against the variation of foreign currency loan principal and interest against the Brazilian real, which affect the amounts in Brazilian reais necessary to pay the foreign-exchange-denominated obligations. At September 30, 2005 covered liabilities of U.S.\$427.7 million. In the nine-month period ended September 30, 2005, Embratel recognized a charge to results of operations under these hedges of P.864,339 (P.339,829 in 2004), corresponding to the fluctuation of the exchange rate.

To hedge its exposure to financial risks, the Company entered into interest-rate swaps for the exchange of cash flows for the amount determined by applying agreed interest rates to the notional amount. Under these contracts, the Company agreed to receive the THIE interbank rate and 182 days CETES rate and to pay a fixed rate. The related market interest rates of these swaps are recognized in income.

At September 30, 2005, the Company had peso-denominated interest-rate swaps for a total notional amount of P. 15,900,000. Also the Company had U.S. dollar-denominated interest-rate swaps for a total base amount of U.S.\$ 1,050 million paying a fixed rate and receiving 6 month Libor and U.S. \$1,050 million paying 6 month Libor and receiving a fixed rate. At December 31, 2004, the Company had the same position. In the nine-month period ended September 30, 2005, the Company recognized a net expense under these contracts of P.226,938 included in comprehensive financing cost (P. 423,561 in 2004). This amount included an expense of P.272,196 as a result of the replacement of peso-denominated interest rate swaps contracts.

**7. Accounts Payable**

Accounts payable consist of the following:

|                         | <b>September 30,</b>        | <b>December 31,</b>         |
|-------------------------|-----------------------------|-----------------------------|
|                         | <b>2005</b>                 | <b>2004</b>                 |
|                         | <u>                    </u> | <u>                    </u> |
| Suppliers               | P. 5,994,002                | P. 11,662,303               |
| Sundry creditors        | 4,966,147                   | 1,899,252                   |
| Net settlement payables | 785,113                     | 731,473                     |
| Related parties         | 1,492,564                   | 1,876,058                   |
| Other                   | 3,467,623                   | 2,153,134                   |
|                         | <u>                    </u> | <u>                    </u> |
| <b>Total</b>            | <b>P. 16,705,449</b>        | <b>P. 18,322,220</b>        |
|                         | <u>                    </u> | <u>                    </u> |

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At September 30, 2005 and December 31, 2004, TELMEX had the following foreign currency denominated assets and liabilities:

|                     | Foreign currency in millions      |          |                                  |          |  |  |
|---------------------|-----------------------------------|----------|----------------------------------|----------|--|--|
|                     | Exchange rate<br>at September 30, |          | Exchange rate<br>at December 31, |          |  |  |
|                     | 2005                              | 2005     | 2004                             | 2004     |  |  |
| <b>Assets:</b>      |                                   |          |                                  |          |  |  |
| U.S. dollar         | 682                               | P. 10.85 | 1,305                            | P. 11.26 |  |  |
| Argentinean peso    | 121                               | 3.73     | 107                              | 3.79     |  |  |
| Brazilian real      | 2,632                             | 4.88     | 3,060                            | 4.24     |  |  |
| Chilean peso        | 25,570                            | 0.02     | 20,168                           | 0.02     |  |  |
| Colombian peso      | 13,664                            | 0.0047   | 10,433                           | 0.0047   |  |  |
| Peruvian sol        | 100                               | 3.24     | 80                               | 3.43     |  |  |
| <b>Liabilities:</b> |                                   |          |                                  |          |  |  |
| U.S. dollar         | 7,821                             | P. 10.85 | 7,485                            | P. 11.26 |  |  |
| Argentinean peso    | 158                               | 3.73     | 62                               | 3.79     |  |  |
| Brazilian real      | 2,018                             | 4.88     | 3,512                            | 4.24     |  |  |
| Chilean peso        | 46,337                            | 0.02     | 33,733                           | 0.02     |  |  |
| Colombian peso      | 23,451                            | 0.0047   | 13,277                           | 0.0047   |  |  |
| Peruvian sol        | 100                               | 3.24     | 11                               | 3.43     |  |  |
| Euro                | 51                                | 13.07    | 61                               | 14.17    |  |  |

**9. Contingencies****Contingencies of Mexico**

a) In February 1998, the Federal Commission of Economic Competition (COFECO) determined that Teléfonos de México, S.A. de C.V. has substantial power in what it referred to as five telecommunications markets so that, in conformity with Article 63 of the Federal Telecommunications Act, COFETEL may impose specific obligations with respect to rates charged and quality of services and information.

The Company's external lawyers who are handling this matter are of the opinion that this finding is unjustified. Consequently, Teléfonos de México, S.A. de C.V. filed an appeal in the Federal District Court and obtained protection and shelter under Mexican Federal law. In September 2004, COFECO handed down a new ruling supporting the findings with respect to the substantial power that Teléfonos de México, S.A. de C.V. exercises over five telecommunications markets. Teléfonos de México, S.A. de C.V. filed an appeal in the Federal District Court. In October 2004, such appeal was admitted by the court and the final ruling is still pending.

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As a result, the COFECO has initiated other proceedings against Teléfonos de México, S.A. de C.V. that have also being appealed.

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**(In thousands of Mexican pesos with purchasing power at September 30, 2005)**

b) In December 1995, a competitor that provides cellular telephone services reported Teléfonos de México, S.A. de C.V. to the COFECO for alleged monopolistic practices and undue concentration.

In July 2001, the COFECO ruled that Teléfonos de México, S.A. de C.V. was responsible for monopolistic practices and undue concentration. Teléfonos de México, S.A. de C.V. filed an appeal for reconsideration against the ruling, but the appeal was declared unfounded and the ruling confirmed.

The respective defense against the confirmation of the ruling has been presented before the Federal Court of Justice for Tax and Administrative Matters.

c) The Mexican Social Security Institute (IMSS) audited Teléfonos de México, S.A. de C.V. for the 1997-2001 period. At the conclusion of the audit, it was determined that Teléfonos de México, S.A. de C.V. owed a total of approximately P. 330,000 (historical amount) in taxes, fines, surcharges and restatements at July 2, 2003. Teléfonos de México, S.A. de C.V. filed an appeal before the Federal Court of Justice for Tax and Administrative Matters, and in accordance with Mexican laws, by means of a bank trust guaranteed payment of such tax liability through August 1, 2006. The Company's external lawyers who are handling this matter are of the opinion that although the Company's appeal is well founded, there is no guarantee that it will prevail.

**Contingencies of Embratel, Star One and Vésper**

***Brazilian value-added goods and services tax (ICMS)***

Embratel received a number of tax assessments alleging underpayment of ICMS on services provided, including international services and others, considered by Embratel as exempted or non-taxable for ICMS purposes and others tax assessment related to the use of ICMS tax credit allegedly undue by the tax authorities. Amounts of approximately P. 2,064,232 are considered as probable losses in the cases and were duly accrued in the subsidiary's financial statements. Amounts considered by legal counsels that the likelihood of an unfavorable loss is possible are approximately P. 3,423,949; as a result, no provisions have been recorded for such amounts.

During the third quarter of 2005, part of these contingencies already classified as possible, was reclassified to probable, amounting to P. 1,034,575, due to some partially unfavorable decisions, and the reassessment made by the subsidiary Embratel's legal counsels, which recommended additional provisions of part of those amounts.

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In July 2002, Star One received two tax assessments in the state of Rio de Janeiro demanding ICMS in the amount of approximately P. 1,152,228. These tax assessments refer to ICMS tax on broad band Internet services and satellite use. In March 2004, Star One was assessed by the tax authorities of Brazilian Federal District in the amount of P. 96,699 also related to ICMS on satellite use and other obligations. Based on opinion of the Star One management's and Legal Counsel's which consider the probability of loss as possible, no provision was recorded in the financial statements.

The subsidiaries Vésper S.A. and Vésper Sao Paulo S.A. have ICMS tax assessments in the amount of P. 108,231, which has been accrued.

The Company's external lawyers who are handling this matter are of the opinion that although the Company's case is well founded, there is no guarantee that it will prevail.

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**(In thousands of Mexican pesos with purchasing power at September 30, 2005)**

***Income Tax on Inbound International Income***

Based on its legal advisors' opinion, Embratel believes that the foreign operating income from telecommunications services (inbound traffic) is not subject to taxation. In connection with this matter, in March 1999, the Brazilian Federal Tax Agency (SRF) assessed the subsidiary in the amount of P. 1,402,394 approximately for failing to pay the related income tax for the years 1996 and 1997. Embratel appealed to the Taxpayers Council against this decision, which is still pending.

In June 1999, Embratel was further assessed for non-payment of income tax on net foreign source income for 1998 amounting to approximately P. 314,402.

As a result of an unfavorable ruling of the administrative defense contesting this assessment, the Company requested a writ of mandamus, which was initially rejected by the court. However, such ruling was subsequently modified so as to reflect a favorable decision for Embratel. Based on the opinion of the subsidiary's management and its legal advisors, who consider the probability of loss as possible, no provisions have been recorded in the financial statements for the related amounts of the suits.

The Company's external lawyers who are handling this matter are of the opinion that although the Company's case is well founded, there is no guarantee that it will prevail.

***Brazilian Social Welfare Tax on Service Exports (PIS)***

In August 2001, Embratel received a tax assessment from the Brazilian Federal Revenue Service (SRF) totaling approximately P. 776,289 for payment of the PIS prior to 1995, which had been offset in accordance with Brazilian tax law. Based on the facts and arguments provided, and also on the opinion of the Company's external lawyers, Embratel's management considered the probability of loss as possible and no provision was recorded in the financial statements for this matter. The Company's external lawyers who are handling this matter are of the opinion that although the Company's case is well founded, there is no guarantee that it will prevail.

***Brazilian Finance Tax for Service Export Security Tax (COFINS)***

There is also a tax assessment against Embratel amounting approximately of P. 1,669,755 related to the COFINS exemption on the exportation of telecommunication services for revenues through the end of 1999. According to management, there were several errors in the computation of this tax made by the government auditor and, consequently, such amount was later reduced by approximately P. 1,074,111. Embratel appealed

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the case in the highest administrative court and in July 2003, a ruling was issued requiring the claim to be returned to the first administrative level. A new decision was issued by the first administrative level confirming that the remaining up dated amount was approximately P. 1,115,158. Embratel appealed to a higher administrative level which is still pending decision.

Based on the facts and arguments provided, and also on the opinion of the Company s external lawyers, Embratel s management considers the probability of a loss as possible. Accordingly, no provision was recorded in the financial statements for this matter.

The Company s external lawyers who are handling this matter are of the opinion that although the Company s case is well founded, there is no guarantee that it will prevail.

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Certain cases are in an advanced stage of the litigation process and, according to Embratel's external lawyers, the subsidiary stands a chance of losing at least some of the cases; consequently, P. 753,889 (restated) has been provided for possible unfavorable rulings. For other litigation totaling P. 100,542, Embratel provided guarantee deposits of P. 52,900. According to the Company's external lawyers, although the Company's arguments in this case are well-grounded, there is no guarantee of a favorable outcome.

**10. Related Parties**

In the nine-month periods ended September 30, 2005 and 2004, the Company had the following significant transactions with related parties:

|   | <u>2005</u>  | <u>2004</u>  |
|---|--------------|--------------|
| <i>Investment and expenses:</i>   |              |              |
| Purchase of materials, inventories and fixed assets   | P. 4,348,211 | P. 3,823,363 |
| Acquisition of 60% of Techtel   |              | 880,253      |
| Payment of insurance premiums, fees for administrative and operating services, security trading and other | 2,507,627    | 2,339,902    |
| Payment of CPP interconnection fees   | 6,892,601    | 7,332,499    |
| <i>Revenues:</i>  |              |              |
| Sale of materials and other services  | 837,493      | 761,572      |
| Sale of long distance and other telecommunications services   | 2,971,532    | 2,874,280    |
| Sale of 50% of Technology and Internet LLC  | 42,812       |              |

**11. Stockholders' Equity**

a) At September 30, 2005, capital stock is represented by 22,541 million shares issued and outstanding with no par value, representing the Company's fixed capital (23,665 million at December 31, 2004).

b) During the nine-month period ended September 30, 2005, the Company acquired 1,084 million Series L shares for P. 11,211,285 and 4.4 million Series A shares for P. 46,020. During the nine-month period ended September 30, 2004, the Company acquired 567.8 million Series L shares for P. 11,297,695 and 1.4 million Series A shares for P. 26,694.

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c) Earnings per share are obtained by dividing net income for the period by the weighted average number of shares issued and outstanding during the period. To determine the weighted average number of shares issued and outstanding in the nine-month periods ended September 2005 and 2004, the shares held by the Company have been excluded from the computation.

The diluted earnings per share in the nine-month period ended September 30, 2004 was determined considering the effect of the shares that were delivered as a result of the convertible senior debentures and of the stock options described in Notes 8 and 17 of the audited financial statements. The computation was made by deducting from net income for the period, the comprehensive financing cost, net of income tax and employee profit sharing, derived from the convertible debentures. The adjusted

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income was divided by the weighted average number of shares issued and outstanding, taking into account the number of potentially dilutive shares.

An analysis is as follows:

|  | Nine-month periods ended |               |
|--|--------------------------|---------------|
|  | September 30,            |               |
|  | 2005                     | 2004          |
| Earnings per basic share:  |                          |               |
| Majority net income  | P. 19,835,418            | P. 17,380,148 |
| Weighted average number of shares issued and outstanding (millions)          | 23,084                   | 23,960        |
| Earnings per basic share (in pesos)  | P. 0.859                 | P. 0.725      |
| Earnings per diluted share:  |                          |               |
| Majority net income  | P. 19,835,418            | P. 17,380,148 |
| Comprehensive financing cost (net of income tax and employee profit sharing) |                          | 429,121       |
| Adjusted income  | P. 19,835,418            | P. 17,809,269 |
| Weighted average number of shares issued and outstanding (millions)          | 23,084                   | 23,960        |
| Add:   |                          |               |
| Potentially dilutive shares  |                          | 654           |
| Weighted average number of diluted shares issued and outstanding (millions)  | 23,084                   | 24,614        |
| Earnings per diluted share (in pesos)  | P. 0.859                 | P. 0.724      |

d) At September 30, 2005, accumulated other comprehensive income includes the gain on the market value of swaps of P.238,202 and the deficit from restatement of stockholders' equity of P.68,638,517, net of deferred taxes, and the gain on the translation of foreign entities of P. 2,495,966 (deficit from restatement of stockholders' equity, net of deferred taxes, of P.68,209,024 and the gain on the translation of foreign entities of P.783,324 at December 31, 2004).

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An analysis of comprehensive income for the nine-month periods ended September 30, 2005 and 2004 is as follows:

|   | <u>2005</u>          | <u>2004</u>          |
|---|----------------------|----------------------|
| Net income of the period  | P. 20,575,137        | P. 17,404,273        |
| Other comprehensive income:                                     |                      |                      |
| Effect of instruments available for sale                        | 1,124,985            | (2,120,203)          |
| Effect of market value of swaps, net of deferred taxes          | (72,597)             |                      |
| Effect of translation of foreign entities, net                  | 2,929,558            | 1,404,226            |
| Deficit from holding non-monetary assets, net of deferred taxes | (2,652,813)          | (914,107)            |
|   | <u>1,329,133</u>     | <u>(1,630,084)</u>   |
| Other comprehensive income                                      | 1,329,133            | (1,630,084)          |
|   | <u>P. 21,904,270</u> | <u>P. 15,774,189</u> |
| Comprehensive income  | <u>P. 21,904,270</u> | <u>P. 15,774,189</u> |

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## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(In thousands of Mexican pesos with purchasing power at September 30, 2005)

**12. Income Tax**

An analysis of income tax provisions for the nine-month periods ended September 30, 2005 and 2004 is as follows:

|   | 2005                | 2004                 |
|---|---------------------|----------------------|
| Current period  | P. 11,540,430       | P. 11,094,729        |
| Deferred tax, net of related monetary gain of P.321,495 (P.766,515 in 2004) | (2,104,808)         | (498,528)            |
| <b>Total</b>  | <b>P. 9,435,622</b> | <b>P. 10,596,201</b> |

On December 1, 2004, an annual gradual decrease in the corporate income tax rate was approved, starting in 2005 until the rate reaches 28% in 2007. The effect that this tax-rate change on deferred taxes had the change occurred as of September 30, 2004, would have been a credit of P.2.6 billion, approximately, to results of operations in the nine-month period ended September 30, 2004 (8.9 % of pretax income).

The increase in deferred taxes derives mainly from the decrease in net projected asset and beginning in 2005 from the effect of employee profit sharing.

The temporary differences on which the Company (excluding the Latin American subsidiaries) recognized deferred taxes consist of the following:

|   | September 30,<br>2005 | December 31,<br>2004 |
|---|-----------------------|----------------------|
| Deferred tax asset :  |                       |                      |
| Allowance for doubtful accounts and slow-moving inventories | P. 743,690            | P. 708,224           |
| Tax loss carryforwards                                      | 73,171                | 79,093               |
| Advance billings  | 614,067               | 358,064              |
| Liability provisions  | 926,103               | 942,130              |
| Employee profit sharing                                     | 639,896               |                      |
|   | <b>2,996,927</b>      | <b>2,087,511</b>     |
| Deferred tax liability:                                     |                       |                      |

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|                                  |                     |                     |
|----------------------------------|---------------------|---------------------|
| Fixed assets                     | (11,316,599)        | (12,256,483)        |
| Inventories                      | (313,500)           | (411,809)           |
| Licenses                         | (144,430)           | (136,606)           |
| Net projected asset              | (6,424,897)         | (7,297,146)         |
| Prepaid expenses                 | (393,405)           | (416,570)           |
| Derivative financial instruments | (55,510)            |                     |
|                                  | <u>(18,648,341)</u> | <u>(20,518,614)</u> |
| Net deferred tax, liability      | P. (15,651,414)     | P. (18,431,103)     |

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**Table of Contents****TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(In thousands of Mexican pesos with purchasing power at September 30, 2005)**

The temporary differences on which the Latin American subsidiaries recognized deferred taxes consist of the following:

|                                  | <b>September 30,</b>        | <b>December 31,</b>         |
|----------------------------------|-----------------------------|-----------------------------|
|                                  | <b>2005</b>                 | <b>2004</b>                 |
|                                  | <u>                    </u> | <u>                    </u> |
| Deferred tax asset:              |                             |                             |
| Fixed assets                     | P. 2,000,218                | P. 1,063,815                |
| Allowance for doubtful accounts  | 2,905,087                   | 2,702,731                   |
| Tax loss carryforwards           | 1,686,068                   | 1,529,096                   |
| Advance billings                 |                             | 66,203                      |
| Liability provisions             | 980,357                     | 789,229                     |
|                                  | <u>                    </u> | <u>                    </u> |
|                                  | 7,571,730                   | 6,151,074                   |
|                                  | <u>                    </u> | <u>                    </u> |
| Deferred tax liability:          |                             |                             |
| Licenses                         | (943,793)                   | (674,542)                   |
| Inventories                      | (144,237)                   | (49,959)                    |
| Advance billings                 | (509,773)                   |                             |
| Derivative financial instruments | (120,230)                   |                             |
|                                  | <u>                    </u> | <u>                    </u> |
|                                  | (1,718,033)                 | (724,501)                   |
|                                  | <u>                    </u> | <u>                    </u> |
| Net deferred tax, asset          | P. 5,853,697                | P. 5,426,573                |
|                                  | <u>                    </u> | <u>                    </u> |

**13. Segments**

TELMEX operates primarily in two segments: local and long-distance telephone services and operates in two geographic segments: Mexico and Latin America. Local telephone service corresponds to fixed local wired service. The long-distance service includes both domestic and international services. Other segments include the long-distance calls originated in public and rural telephones, corporate networks, Internet, directories and other services. Additional information related to the Company's operations is provided in Note 1 of the audited financial statements. The following summary shows the most important segment information, which has been prepared on a consistent basis with the audited financial statements included in the Company's annual report on Form 20-F.

**Table of Contents****TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(In thousands of Mexican pesos with purchasing power at September 30, 2005)**

(Amounts in millions of Mexican pesos  
with purchasing power at September 30, 2005)

|                               | Mexico           |                  |                   |                      | Consolidated<br>total |
|-------------------------------|------------------|------------------|-------------------|----------------------|-----------------------|
|                               | Local<br>Service | Long<br>distance | Other<br>segments | Latin<br>America (1) |                       |
| At September 30, 2005         |                  |                  |                   |                      |                       |
| Revenues:                     |                  |                  |                   |                      |                       |
| External revenues             | P. 56,481        | P. 18,696        | P. 16,307         | P. 30,222            | P. 121,706            |
| Intersegment revenues         | 7,178            |                  | 860               |                      | P. (8,038)            |
| Depreciation and amortization | 9,450            | 1,924            | 2,886             | 4,587                | 18,847                |
| Operating income              | 17,855           | 6,255            | 8,927             | 2,580                | 35,617                |
| Segment assets                | 246,319          | 48,261           | 44,985            | 97,305               | 436,870               |
| At September 30, 2004         |                  |                  |                   |                      |                       |
| Revenues:                     |                  |                  |                   |                      |                       |
| External revenues             | P. 60,205        | P. 19,248        | P. 14,648         | P. 6,620             | P. 100,721            |
| Intersegment revenues         | 9,023            |                  | 920               |                      | P. (9,943)            |
| Depreciation and amortization | 10,671           | 2,220            | 3,048             | 1,284                | 17,223                |
| Operating income              | 21,225           | 4,432            | 6,323             | (123)                | 31,857                |
| Segment assets                | 241,942          | 49,677           | 43,702            | 90,972               | 426,293               |

(1) Revenues of the Latin American subsidiaries derive principally from long-distance services.

Intersegmental transactions are reported at fair value. Comprehensive financing cost and provisions for income tax and employee profit sharing are not assigned to the segments; they are handled at the corporate level.

Segment assets include plant property and equipment (on a gross basis) construction in progress, advances to suppliers of equipment and inventories for operation of the telephone plant.

**14. Differences Between Mexican and U.S. GAAP**

The unaudited condensed consolidated financial statements of the Company are prepared in accordance with generally accepted accounting principles in Mexico ( Mexican GAAP ), which in certain respects differ significantly from generally accepted accounting principles in the United States ( U.S. GAAP ).

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The following reconciliation to U.S. GAAP does not include the reversal of the adjustments to the financial statements for the effects of inflation required under Mexican GAAP (Bulletin B-10), because the application of Bulletin B-10 represents a comprehensive measure of the effects of price level changes in the Mexican economy and, as such, is considered a more meaningful presentation than historical cost-based financial reporting for both Mexican and U.S. accounting purposes.

The principal differences between Mexican GAAP and U.S. GAAP, as they relate to the Company, are described in Note 19 to the audited financial statements or are listed below, with an explanation, where appropriate, of the adjustments that affect operating income, net income, stockholders' equity and resources provided by operating and financing activities for the nine-month periods ended September 30, 2005 and 2004.

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**Table of Contents****TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(In thousands of Mexican pesos with purchasing power at September 30, 2005)***Cash flow information:*

Under Mexican GAAP, the Company presents consolidated statements of changes in financial position, as described in Note 1. The changes in the consolidated financial statement balances included in this statement constitute resources provided by and used in operating, financing and investing activities stated in constant pesos (including monetary and foreign exchange gains and losses).

Statement of Financial Accounting Standards No. 95, Statement of cash flows, does not provide guidance with respect to inflation adjusted financial statements. In accordance with Mexican GAAP, the changes in current and long-term debt due to restatement in constant pesos, including the effect of exchange differences, is presented in the statement of changes in financial position in the financing activities section. The Company has adopted the guidance issued by the AICPA SEC Regulations Committee's International Practices Task Force in its meeting held on November 24, 1998, encouraging non-U.S. registrants that file price level adjusted financial statements to provide cash flow statements that show separately the effects of inflation on cash flows.

If the monetary gain and the exchange gain or loss related to debt were treated as components of operating activities, summarized consolidated statements of cash flows derived from information prepared in accordance with U.S. GAAP would be as follows:

|   | <b>Nine month periods ended<br/>September 30,</b> |               |
|---|---|---------------|
|   | <b>2005</b>                                       | <b>2004</b>   |
| Cash flows from operating activities:   |   |               |
| Net income under U.S.GAAP   | P. 19,642,927                                     | P. 17,054,865 |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |               |
| Depreciation  | 19,704,922  | 18,632,050    |
| Amortization  | 691,961   | 230,041       |
| Deferred taxes  | (2,410,395)                                       | 361,036       |
| Monetary gain   | (1,501,599)                                       | (2,411,865)   |
| Equity interest in net loss of affiliates   | 59,584  | 77,702        |
| Other   | 186,004   |               |
| Minority interest   | 733,101   | (106,850)     |
| Effect of exchange rate differences on debt                                       | (3,457,226)                                       | 367,289       |
| Investment in marketable securities   | 277,551   | 7,017,770     |
| Change in operating assets and liabilities  | (2,952,445)                                       | (1,353)       |
| Total adjustments   | 11,331,458  | 24,165,820    |
| Net cash provided by operating activities   | 30,974,385  | 41,220,685    |

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|   |                             |                             |
|---|-----------------------------|-----------------------------|
| Cash flows from investing activities:                       |                             |                             |
| Investment in plant, property and equipment and inventories | (15,486,549)                | (11,977,708)                |
| Instruments available for sale                              | 6,992,713                   | (7,396,807)                 |
| Initial cash from subsidiaries acquired                     |                             | 4,392,525                   |
| Subsidiaries and affiliated companies                       | (3,633,957)                 | (9,655,060)                 |
| Other   | (494,189)                   |                             |
|   | <u>                    </u> | <u>                    </u> |
| Net cash used in investing activities                       | (12,621,982)                | (24,637,050)                |
|   | <u>                    </u> | <u>                    </u> |
| Cash flows from financing activities:                       |                             |                             |
| New loans   | 22,046,650                  | 33,382,246                  |
| Repayment loans   | (16,608,110)                | (29,646,548)                |
| Purchase of Company's own shares and cash dividends paid    | (17,615,994)                | (17,566,495)                |
| Stock options exercised                                     | (246,118)                   | 30,824                      |
| Conversion of debt instruments to shares                    |                             | 6,881,271                   |
| Minority Interest   | 996,291                     |                             |
|   | <u>                    </u> | <u>                    </u> |
| Net cash used in financing activities                       | (11,427,281)                | (6,918,702)                 |
|   | <u>                    </u> | <u>                    </u> |
| Effect of inflation accounting                              | (389,333)                   | (550,967)                   |

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## NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)

(In thousands of Mexican pesos with purchasing power at September 30, 2005)

|  | Nine month periods ended<br>September 30, |               |
|--|---|---------------|
|  | 2005                                      | 2004          |
| Net increase in cash and cash equivalents        | 6,535,789                                 | 9,113,966     |
| Cash and cash equivalents at beginning of period | 20,872,085                                | 10,911,830    |
| Cash and cash equivalents at end of period       | P. 27,407,874                             | P. 20,025,796 |

Cash flows from sales of trading securities during the nine-month period ended September 30, 2005 were P. 146,810, and cash flows from purchases of trading securities during the nine-month period ended September 30, 2004 were P. 23,097.

*Changes in accounting policies*

As described in Note 1, the Company adopted new accounting rules that affect the recognition of business combinations and derivative instruments.

Under Mexican GAAP, net assets acquired in a business combination are recognized at their entire fair value, and consequently, minority interests are also adjusted to fair value. Under U.S. GAAP, minority interests are carried at historical cost, and the adjustments to fair value of the net assets are recognized based on the percentage of ownership acquired. For purposes of the reconciliation between Mexican GAAP and U.S. GAAP, the Company has adjusted the fair value of the net assets acquired and its minority interests, to reflect U.S. GAAP accounting for business combinations. This adjustment resulted in an increase of property, plant and equipment and minority interest of P.316,130. Also, the depreciation expense was adjusted and resulted in an increase of P.25,690.

Also, under Mexican GAAP, the acquisition of minority interests is deemed to be a transaction between entities under common control, and any difference between the purchase price paid and the carrying value of the net assets acquired is recognized in equity, whereas under U.S. GAAP, the acquisition of minority interest is treated as a business combination, and any difference between the purchase price paid and the fair value of the net assets acquired is treated as goodwill. The reconciliation of stockholders' equity includes a P.3,723,341 adjustment related to acquisition of minority interests. As a result of this adjustment, negative goodwill for the same amount was recognized and subsequently allocated as a pro rata reduction of the fair value in the long-term non-monetary assets. Also, depreciation expense decreased by P.105,606 as a result of this adjustment.

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Under Mexican GAAP, the adoption of Bulletin C-10, resulted in an increase of stockholders' equity, from derivative instruments that qualify for hedge accounting. As described in our annual financial statements for the year ended December 31, 2004, our derivative instruments were not treated as hedge instruments. However, on January 1, 2005, hedge treatment was given to our derivatives instruments that qualify for hedge accounting on a prospective basis. The recognition of the initial effect under Mexican GAAP had already been recognized in the Company's net income for U.S. GAAP purposes.

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**Table of Contents****TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)****(In thousands of Mexican pesos with purchasing power at September 30, 2005)***Summary*

Net income, operating income and total stockholders' equity, adjusted to take into account the material differences between Mexican GAAP and U.S. GAAP, are as follows:

|  | Nine-month periods ended<br>September 30, |                      |
|--|---|----------------------|
|  | 2005                                      | 2004                 |
|  | <u>Unaudited</u>                          | <u>Unaudited</u>     |
| Net income as reported under Mexican GAAP  | P. 20,575,137                             | P. 17,404,273        |
| U.S. GAAP adjustments:   |   |                      |
| Capitalized interest or net financing cost   | 69,402                                    | 22,874               |
| Depreciation of capitalized interest   | (423,822)                                 | (429,398)            |
| Depreciation expense   | 79,916                                    |                      |
| Deferred income tax under U.S. GAAP included in this reconciliation  | (15,526)                                  | (528,731)            |
| Deferred employee profit sharing under U.S. GAAP included in this reconciliation   | (71,571)                                  | (103,866)            |
| Deferred employee profit sharing   | 392,684                                   | (226,967)            |
| Pension and seniority premium plan cost  | 747,091                                   | 876,153              |
| Difference between the restatement of depreciation expense based on specific indexation factors and on the basis of the NCPI | (1,206,169)                               | (1,209,331)          |
| Effect of derivative instruments   | (172,268)                                 | 592,710              |
| Stock option plan  | 4,940                                     | (46,304)             |
| Effects of inflation accounting on U.S. GAAP adjustments   | 396,214                                   | 596,603              |
| Minority interest on the above U.S. GAAP adjustments   | 6,618                                     | 130,974              |
| Minority interest  | (739,719)                                 | (24,125)             |
| <b>Total U.S. GAAP adjustments</b>   | <b>(932,210)</b>                          | <b>(349,408)</b>     |
| <b>Net income under U.S. GAAP</b>  | <b>P. 19,642,927</b>                      | <b>P. 17,054,865</b> |
| Weighted average common shares outstanding (in millions):  |   |                      |
| Basic  | 23,084                                    | 23,960               |
| Diluted  | 23,084                                    | 24,614               |
| Net income per share under U.S. GAAP (in pesos)  |   |                      |
| Basic  | P. 0.851                                  | P. 0.712             |
| Diluted  | P. 0.851                                  | P. 0.710             |

After giving effect to the foregoing adjustments for pension plan costs, depreciation of capitalized interest, the difference between the restatement of depreciation expense based on specific indexation factors and on the basis of the NCPI and stock option plan expense, as well as to the reclassification of the employee profit sharing expense and the deferred employee profit sharing expense, operating income under U.S.



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GAAP totaled P. 32,890,169 and P. 28,660,698 for the nine-month periods ended September 30, 2005 and 2004, respectively.

|  | <b>September 30,<br/>2005</b> | <b>December 31,<br/>2004</b> |
|--|-------------------------------|------------------------------|
|  |                               |                              |
| Total stockholders' equity under Mexican GAAP                          | P. 114,954,217                | P. 109,790,163               |
| U.S. GAAP adjustments, net of effects of inflation on monetary items:  |                               |                              |
| Capitalized interest or net financing cost                             | 11,779,190                    | 11,703,705                   |
| Accumulated depreciation of capitalized interest or net financing cost | (9,536,044)                   | (9,112,222)                  |
| Plant property and equipment   | (3,438,639)                   |                              |
| Accumulated depreciation   | 79,916                        |                              |

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**Table of Contents****TELÉFONOS DE MÉXICO, S.A. DE C.V. AND SUBSIDIARIES****NOTES TO UNAUDITED CONDENSED CONSOLIDATED FINANCIAL STATEMENTS (CONTINUED)**

(In thousands of Mexican pesos with purchasing power at September 30, 2005)

|  | <b>September 30,<br/>2005</b> | <b>December 31,<br/>2004</b> |
|--|-------------------------------|------------------------------|
|  | <u>                    </u>   | <u>                    </u>  |
| Licenses   | (284,701)                     |                              |
| Deferred income tax on U.S. GAAP adjustments included in this reconciliation   | 1,545,789                     | 1,665,571                    |
| Deferred employee profit sharing on U.S. GAAP adjustments included in this reconciliation  | (99,217)                      | (87,054)                     |
| Deferred employee profit sharing   | (6,757,069)                   | (7,218,218)                  |
| Deferred taxes on the difference between the indexed cost and specific indexation factor valuation of fixed assets and inventories   | (1,874,733)                   | (1,272,134)                  |
| Pension and seniority premium plan cost  | (2,204,721)                   | (3,294,850)                  |
| Difference between the restatement of fixed assets and inventories based on specific indexation factors and on the basis of the NCPI | 6,459,547                     | 4,317,038                    |
| Effect of derivative instruments   |                               | 603,934                      |
| Stock option plan  |                               | (5,030)                      |
| Minority interest on the above U.S. GAAP adjustments   | (827,389)                     | (719,633)                    |
| Minority interest  | (12,326,403)                  | (14,211,842)                 |
|  | <u>                    </u>   | <u>                    </u>  |
| Total U.S. GAAP adjustments net  | (17,484,474)                  | (17,630,735)                 |
|  | <u>                    </u>   | <u>                    </u>  |
| Total stockholders' equity under U.S. GAAP   | P. 97,469,743                 | P. 92,159,428                |
|  | <u>                    </u>   | <u>                    </u>  |

Comprehensive income under U.S. GAAP is comprised as follows:

|  | <b>Nine-month periods ended</b> |                             |
|--|---------------------------------|-----------------------------|
|  | <b>September 30,</b>            |                             |
|  | <u>2005</u>                     | <u>2004</u>                 |
|  | <b>Unaudited</b>                | <b>Unaudited</b>            |
| Net income under U.S. GAAP                                     | P. 19,642,927                   | P. 17,054,865               |
| Other comprehensive income under U.S. GAAP:                    |                                 |                             |
| Deferred taxes allocated to equity, net of effect of inflation | 767,176                         | 1,863,473                   |
| Effect of instruments available for sale                       | 1,124,985                       | (2,120,203)                 |
| Effect of hedge accounting, net of deferred taxes              | (72,597)                        |                             |
| Effect of translation of foreign entities, net                 | 1,712,642                       | 191,445                     |
|  | <u>                    </u>     | <u>                    </u> |
| Other comprehensive income under U.S. GAAP                     | 3,532,206                       | (65,285)                    |
|  | <u>                    </u>     | <u>                    </u> |
| Comprehensive income under U.S. GAAP                           | P. 23,175,133                   | P. 16,989,580               |
|  | <u>                    </u>     | <u>                    </u> |



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Exhibit 2

**TELEFONOS DE MEXICO, S.A. DE C.V. AND SUBSIDIARIES****CALCULATION OF RATIO OF EARNINGS TO FIXED CHARGES**

SUPPLEMENTS EXHIBIT 7.1 TO FORM F-3 (SEC File No. 333-111040)

Filed with the SEC on December 10, 2003

Thousands of Mexican pesos with purchasing power at September 30, 2005

|   | <u>Nine months ended on<br/>September 30, 2004(1)</u> | <u>Nine months ended on<br/>September 30, 2005(1)</u> |
|---|---|---|
| <b>Mexican GAAP:</b>  |   |   |
| Income before income tax and employee profit sharing                              | 30,134,518  | 32,320,645  |
| <b>Fixed charges:</b>   |   |   |
| Interest expense  | 4,580,312   | 5,795,655   |
| <b>Earnings under Mexican GAAP</b>  | <u>34,714,830</u>                                     | <u>38,116,300</u>                                     |
| <b>Mexican GAAP:</b>  |   |   |
| Employee profit sharing   | 2,056,342   | 2,250,302   |
| <b>U.S. GAAP:</b>   |   |   |
| Total U.S. GAAP adjustments, net  | (349,408)   | (932,210)   |
| Deferred income tax   | (528,731)   | (15,526)  |
| Interest capitalized during the period  | 22,874  | 69,402  |
| Depreciation of capitalized interest  | (429,398)   | (423,822)   |
| <b>U.S. GAAP adjustments without deferred income tax and capitalized interest</b> | <u>585,847</u>  | <u>(562,264)</u>                                      |
|   | <u>33,244,335</u>                                     | <u>35,303,734</u>                                     |
| <b>Earnings under U.S. GAAP</b>   |   |   |
| <b>Fixed charges:</b>   |   |   |
| Interest expense under U.S. GAAP  | 4,557,438   | 5,726,253   |
| Interest capitalized during the period  | 22,874  | 69,402  |
| <b>Fixed charges under U.S. GAAP</b>  | <u>4,580,312</u>                                      | <u>5,795,655</u>                                      |

|                     |            |            |
|---------------------|------------|------------|
| <b>Mexican GAAP</b> | <b>7.6</b> | <b>6.6</b> |
| <b>U.S. GAAP</b>    | <b>7.3</b> | <b>6.1</b> |

**(1) Constant pesos as of September 30, 2005.**

